

ISLAMIC FINANCIAL CONTRACTING FORMS IN SAUDI ARABIA: LAW AND PRACTICE

A thesis submitted for the degree of Doctor of Philosophy

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ABSTRACT

The main objective of this research is to examine whether the current practices of Islamic banking and financial activities in Saudi Arabia are compatible with the principles of *Shariah*. This examination includes the current uses of *sukuk* (Islamic bonds), the models of *takaful* (Islamic insurance) and accepted risk transfer mechanisms in Islamic structured finance (Islamic derivatives). The second purpose is to investigate the basic laws of banking and financial activities in Saudi Arabia and examine whether they are compatible with *Shariah* principles. The final aim is to suggest solutions to the absence of regulatory and supervisory systems of Islamic finance in Saudi Arabia by proposing a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia.

The research findings show that there are no specific laws and regulations governing Islamic banking and financial activities in Saudi Arabia. In addition, there is no independent central *Shariah* board to regulate and supervise Islamic banking and financial activities in Saudi Arabia, nor are there any specialised commercial courts to look into banking issues. The research finds that there are some articles in the law of supervision of cooperative insurance companies in Saudi Arabia, and its implementing regulations, which do not comply with *Shariah*, and in addition, there is some incompatibility between the law and its implementing regulations. The final finding is that the issuance of *sukuk* and Islamic financial derivatives in Saudi Arabia are not consistent with *Shariah* requirements, due to the absence of regulatory policies and supervisory harmonisation, while Islamic insurance needs to amend some articles of the law of supervision of cooperative insurance companies in Saudi Arabia, and its implementing regulations, in order to comply with *Shariah* and also to avoid incompatibility between them.

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DECLARATION

I hereby declare that the work in this thesis is my own work and all quotations have been distinguished by quotation marks. This work has not been submitted in substance for any other degree or award at this or any other university or place of learning, nor is being submitted concurrently in candidature for any degree or other award.

Ali Saeed Al-Shamrani

ABBREVIATIONS USED

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCL	Banking Control Law
BIB	Bahrain Islamic Bank
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
CBA	Central Bank of Malaysia Act 2009
CBB	Central Bank of Bahrain
CBK	Central Bank of Kuwait
CMA	Capital Market Authority
CML	Capital Market Law
CMSA	Capital Markets and Services Act 2007
CRSD	Committee for the Resolution of Securities Disputes
FASB	Financial Accounting Standards Board
FSA	Financial Services Authority
GCC	Gulf Cooperation Council
GFH	Gulf Finance House
GWP	Gross Written Premiums
IBB	Islamic Bank of Britain
ICCS	Islamic Cross Currency Swap
IDB	Islamic Development Bank
IFA	Islamic Fiqh Academy

IFI	Islamic Financial Institution
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IIFA	International Islamic Fiqh Academy
IIFEF	Islamic International Foundation for Economics & Finance
IIFM	International Islamic Financial Market
IMF	International Monetary Fund
IPO	Initial Public Offering
IPRS	Islamic Profit Rate Swap
IRS	conventional Interest Rate Swap
LIBOR	London Interbank Offered Rate
MR	Malaysian Ringgit
NCB	National Commercial Bank of Saudi Arabia
OIC	Organisation of the Islamic Conference
PA	Participants' Account
PB	Participants' Body
PLS	Profit-and-Loss Sharing
SA	Shareholders' Account
SABB	Saudi Arabia British Bank
SAC	Shariah Advisory Council of Bank Negara Malaysia
SAC	Shariah Advisory Council
SAMA	Saudi Arabian Monetary Agency

SB	Shareholders' Body
SBs	Shariah Boards
SC	Securities Commission Malaysia
SCSAC	Securities Commission Shariah Advisory Council
SPV	Special Purpose Vehicle
SS	Shariah supervisory
SSAC	Saudi Shariah Advisory Council
SSB	Shariah Supervisory Board
STSL	Solidarity Trust Services Limited
UAE	United Arab Emirates
UK	United Kingdom
US	United States of America
USD	United States Dollar

GLOSSARY

Al-Dayyah - substitute penalty

Allah - God

Aqd - contract

Aqilah - the paternal relatives who used to pay the blood money in ancient pre-Islamic Arabia

Ayah - verse

bai - sale

Bai Bithaman ajil - deferred payment sale

Bai Salam - Forward Selling

bai-al-dayn-bi-al-dayn - the sale of a debt for a debt

bai-al-kali-bi-al-kali - the exchange of a delayed counter value for another delayed counter value

bai-el-Inah - fictitious sale

Bayt al Mal - treasury of the community

Fard - an obligatory duty

Fasid - invalid

Fatwas - religious opinion concerning Islamic law

Fidyah - ransom of prisoners of war

Fiqh - Islamic jurisprudence

Gharar - contractual ambiguity

Hadith - report of the sayings or actions of the prophet Muhammed

Haram - an action which is absolutely forbidden and punishable

Ijara - leasing contract

Ijma - consensus

Ijtihad - self-exertion

Istihsan - something preferable

Istishab - legal presumption

Istislah - public interest

Istisna - order to manufacture

Iwad - substitute

Khiyar - option / choice

khiyar al majlis - option of the contracting session

khiyar al-shart - option by stipulation
Madhhab - school of classical Islamic jurisprudence
Maisir - gambling
Mubah - an action which is permitted
Mudarabah - Profit and Loss Sharing
Mudarib - the entrepreneur
Mujir - the lessor
Mukruh - an action which is disapproved
Murabaha - cost plus sale
Musharaka - partnership or joint venture
Mustahab - an action which is rewarded
Mustajir - the lessee
Qardh-al-hasan - benevolent or interest free loans
Qiyas - analogical reasoning by Muslim judges
Quran - the Holy Book of Islam
Rabb-ul-mal - owner of capital
Riba - interest
Riba al-Fadl - exchange surplus interest
Riba an-Nasia - delayed interest
Sahih - valid
Shariah - Islamic law
Sharika al Mufawadah - full authority and obligation or universal partnership
Sharika aqd - contractual partnership
Sharika mulk - partnership by asset ownership
Sharikah al-wujuh - partnership by creditworthiness
Sharikat al-Inan - unequal partnership
Sharikat al-mudaraba - labour partnership
Sukuk - Islamic bonds
Sunnah - the way of the Prophet Muhammed
Taawun - mutual cooperation
Tabaru - donation
Tadawul - Saudi Stock Exchange
Takaful - Islamic insurance
Taqlid - the opinions of other scholars

Tawarruq - monetization of commodities

Urban - earnest money

Urf - custom

Waad - unilateral Promise

Wakalah - agency

Wakeel - agent

Zakat - obligatory almsgiving

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CHAPTER ONE: INTRODUCTION

1.1 Overview

With the advent of globalisation and economic liberalisation, it is becoming increasingly difficult to ignore the Islamic financial industry. Islamic finance is growing at a rate of approximately 15% per annum.¹ It is practised in more than 500 Islamic financial institutions (IFIs) operating in the world in over 75 countries including Western ones.² Currently, the circulating assets of Islamic finance are estimated to have reached US \$ 1.4 trillion, which means that Islamic finance is one of the fastest growing financial sectors in the world, and in particular, in the Gulf Cooperation Council (GCC), due to the oil boom.³

Islamic finance is based on *Shariah*, which is derived from the Holy Book of Islam (*Quran*), the authorised sayings or actions of the prophet Muhammed (*Sunnah*), the unanimous consensus of Muslims scholars on a given issue on a particular time (*Ijma*) and *Qiyas* which is considered derivation of a law on the analogy of an existing law if the basis of the two are the same.⁴ The basic principles of Islamic finance are the prohibition of *riba* (usury or interest), *gharar* (contractual ambiguity), and *maisir* (speculation or gambling); and equity profit-and-loss sharing (PLS).⁵ Therefore, any activities not compatible with the provisions of *Shariah* are forbidden for Muslims.⁶

Saudi Arabia is one of the largest markets for Islamic banking and finance in the world, accounting for a substantial share of the sector's total assets, valued at nearly \$1.6 trillion.⁷ Currently, in Saudi Arabia, there are four Islamic banks and 11 branches of foreign banks providing Islamic banking and financial services in accordance with the principles of

¹ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based' *Science Direct* (2009) 17 (1) 126.

² Yoko Ishigaki, 'The development of the Islamic financial market - The Tokyo sukuk case study' (2009) *Company Lawyer* 30 (5) 3; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 15.

³ Ibid.

⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 41.

⁵ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 176.

⁶ Ibid.

⁷ See the official website of The Islamic Development Bank (IDB), available at: http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/IRTI_Annual_Report_1433H_2012_En.pdf [Accessed 30 December 2013].

Shariah.⁸ There is also the Saudi Stock Exchange (*Tadawul*), which is considered one of the most highly capitalized stock exchanges in the Arab world, where the issuance of *sukuk* in Saudi Arabia is traded on the Saudi Stock Exchange.⁹ In addition, Saudi Arabia's *takaful* insurance industry is considered the largest one in the world. In 2011, Gross Written Premiums (GWP) in the Saudi insurance market reached SR 18.504 billion, up from SR 16.387 billion in 2010.¹⁰

1.2 Research Significance

The significant contribution of this thesis is to propose a legislative and regulatory framework for Islamic banking and finance including Islamic insurance (*takaful*) in Saudi Arabia. This proposal is due to the absence of specific laws governing all Islamic banking and financial activities, including *takaful* business, in Saudi Arabia, and also the lack of an independent central *Shariah* board as the highest *Shariah* authority in the field of Islamic banking and finance in Saudi Arabia to regulate and supervise Islamic banking and financial activities. This proposal might therefore be regarded as a first step in the enactment of a law regulating Islamic financial institutions in Saudi Arabia.

This thesis provides the baseline information needed to adopt a specific law and also to establish a Shariah Advisory Council to regulate and supervise all Islamic banking and financial activities including *takaful* business in Saudi Arabia. This study would be beneficial to the Saudi Ministry of Finance, the Saudi Arabian Monetary Agency (SAMA) and the Capital Market Authority (CMA) in order to develop Islamic banking and financial activities in Saudi Arabia.

It also gives a comprehensive and critical review of Islamic finance on the basis of comparative analysis with conventional finance from the *Shariah* point of view. The purpose of this comparison is to understand the underlying philosophy of both Islamic and conventional finance in order to determine the main similarities and differences between

⁸ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx [Accessed 26 November 2013].

⁹ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx [Accessed 26 November 2013].

¹⁰ Saudi Arabian Monetary Agency, 'Insurance Supervision Department', *The Saudi Insurance Market Report 2011*, <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/SUR_InsuaMarketSurvey2011_En_2011.> [Accessed 18 May 2013].

them and then evaluate them from the *Shariah* point of view. This thesis also adopts a comparative approach between Saudi Arabia and Malaysia in order to determine the advantages and disadvantages of Islamic financial contracting forms in Saudi Arabia and then attempt to transfer the Malaysian experience to Saudi Arabia.

This thesis investigates how *sukuk* work in Saudi Arabia, and the extent to which the issuance of them in Saudi Arabia is consistent with *Shariah* requirements. Furthermore, it gives a critical analysis of the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations, and examines whether Saudi insurance law is consistent with Islamic *Shariah*. It also offers a comprehensive and critical review of Islamic derivatives as an alternative to conventional derivatives in Saudi Arabia, and examines whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*.

1.3 Motivation

There are three reasons for choosing three types of Islamic financial contracting forms in Saudi Arabia; namely, Islamic bonds (*sukuk*), Islamic insurance (*takaful*) and Islamic financial derivatives. The first reason is the remarkable growth of the Islamic financial market and huge Islamic mutual funds in Saudi Arabia which is considered the world's largest Islamic financial market. The Saudi cooperative insurance market is considered the largest *takaful* industry in the world, having reached SR 18.504 billion in 2011, up from SR 16.387 billion in 2010.¹¹ With regard to the *sukuk* market in Saudi Arabia, this has grown substantially in recent years due to the vast financing requirements necessitated by a proactive public spending policy.¹² The Saudi *sukuk* market contributed more than 14 percent to the total value of *sukuk* issued globally in 2010, by when the global *sukuk* market had reached a record SAR 180 billion.¹³

The next reason is the multiplicity of laws and supervisory authorities on the activities of Islamic finance in Saudi Arabia. There are three laws and also a set of regulations that regulate Islamic bonds, Islamic insurance and Islamic financial derivatives side-by-side with

¹¹ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: http://www.sama.gov.sa/sites/samaen/Insurance/InsuranceLib/SUR_InsuaMarketSurvey2011_En_2011, [Accessed 18 May 2013].

¹² Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations', (Unpublished PhD Thesis, Durham University 2012) 245.

¹³ Ibid.

conventional commercial banking businesses in Saudi Arabia. The issuance of *sukuk* in Saudi Arabia is regulated under the Offers of Securities Regulations and the Listing Rules, while Islamic financial derivatives are regulated under the Banking Control Law (BCL) of 1966, and Islamic insurance is regulated under the Law of Supervision of Cooperative Insurance Companies and its implementing regulations. Despite the existence of these laws and regulations, there is not one article that refers to *sukuk* or *takaful* or Islamic financial derivatives. Moreover, the existing law of the BCL 1966 is still applicable and has not been repealed or amended in order to cover a wider range of financial investment instruments, such as Islamic financial derivatives and Islamic *sukuk*.¹⁴ This means that IFIs in Saudi Arabia operate under a strange legal framework where there is no specific law governing Islamic banking and finance in spite of Saudi Arabia being considered the world's largest Islamic financial market. Furthermore, there is a conflict or incompatibility between some articles in the Law of Supervision of Cooperative Insurance Companies and its implementing regulations.¹⁵ This conflict has generated serious arguments between Islamic scholars in Saudi Arabia about the legality of cooperative insurance in Saudi Arabia.¹⁶ With regard to supervisory authorities, there are different ones that oversee these three types in Saudi Arabia. Islamic insurance and Islamic financial derivatives are supervised by SAMA, whereas Islamic bonds are supervised by CMA. These supervisory authorities oversee Islamic financial contracting forms in Saudi Arabia including these three types without a *Shariah* supervisory board. One of the main tasks of the *Shariah* supervisory board is to ascertain that the operations of Islamic financial institutions or Islamic windows of conventional banks are undertaken according to *Shariah* principles. Therefore, it is difficult to ensure that the operations of Islamic bonds, Islamic insurance and Islamic financial derivatives in Saudi Arabia are compliant with *Shariah*, unless there is a *Shariah* supervisory board issuing *fatwas*, *Shariah* rulings, *Shariah* standards, and governance standards concerning Islamic banking and financial activities in Saudi Arabia.

The third reason is the multiplicity of quasi-judicial committees that oversee Islamic banking and financial activities in Saudi Arabia. The reason for the existence of these committees is the lack of commercial courts in Saudi Arabia to look into Islamic banking and finance

¹⁴ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010 3 (2) 97.

¹⁵ Yuosef Alhumoudi, *Islamic Insurance Takaful and its Application in Saudi Arabia*, Unpublished PhD Thesis, Brunel University 2012) 229-230.

¹⁶ Ibid.

disputes. The problem is that decisions issued by quasi-judicial committees related to Islamic banking and financial disputes are not conclusive or do not have a peremptory character because they are not *Shariah* courts. Moreover, these committees are also not independent; they are linked with the boards of directors of SAMA and CMA and the Ministry of Commerce.

1.4 Research Problem

There are specific laws governing Islamic banking and finance in some Muslim countries, such as the Islamic Banking Act 1983 in Malaysia, the Islamic Banking Law 1983 in Iran and the Banking Regulation Act 2003 in Sudan.¹⁷ In addition, some GCC countries have mentioned Islamic banking in their legislation. For example, in Kuwait, the Central Bank of Law was amended to bring the Islamic banks formally under the jurisdiction of the Central Bank of Kuwait (CBK).¹⁸ In Bahrain, the Central Bank of Bahrain (CBB) issued a rulebook for Islamic Banks¹⁹. In the United Arab Emirates (UAE), Federal Law No. 6 of 1985 mentions ten articles regarding Islamic banking, financial institutions and investment companies.²⁰

In contrast, in Saudi Arabia, there are no specific laws governing Islamic banking and financial activities. Islamic banking and financial activities are regulated and supervised side-by-side with conventional commercial banking businesses by SAMA under the BCL of 1966. Islamic insurance is regulated and supervised side-by-side with conventional insurance by SAMA under the Law of Supervision of Cooperative Insurance Companies and its implementing regulations. The issuance of *sukuk* in Saudi Arabia is regulated and supervised side-by-side with the issuance of shares and debt instruments by CMA under the Offers of Securities Regulations and the Listing Rules.

In addition to the absence of regulatory policies and supervisory harmonisation, there is no independent central *Shariah* board for validating Islamic banking and financial activities so as to ensure their compatibility with the *Shariah* principles. Moreover, there is no uniform

¹⁷ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 126-130.

¹⁸ Kabir Hassan and Mervyn Lewis & Mervyn Lewis, *Handbook of Islamic banking* (Edward Elgar Publishing Limited 2007) 122.

¹⁹ See the official website of the Central Bank of Bahrain (CBB), available at: http://www.cbb.gov.bh/page-p-cbb_rule_book.htm, [Accessed 20 October 2013].

²⁰ Federal Law No. 6 of 1985.

guidance on *Shariah* compliance or uniform interpretation of *Shariah* principles of Islamic banking and financial activities. Furthermore, there are no commercial courts for resolving banking disputes in Saudi Arabia.

Therefore, the main research problem is the absence of regulatory policies and supervisory harmonisation of Islamic banking and financial activities including Islamic bonds, Islamic insurance and Islamic derivatives in Saudi Arabia.

1.5 Thesis aim

The primary aim of thesis is to examine whether the current practices of Islamic banking and financial activities in Saudi Arabia including the current uses of *sukuk* (Islamic bonds), the models of *takaful* (Islamic insurance) and accepted risk transfer mechanisms in Islamic structured finance (Islamic derivatives) are compatible with the principles of *Shariah*. However, the research has a variety of additional aims, which are as follows:

1. To discuss and analyse the basic laws of banking and financial activities in Saudi Arabia and examine whether they are compatible with the principles of *Shariah*.
2. To conduct a comparative study of the Islamic financing contracting forms and the conventional ones.
3. To determine the legal challenges that face Islamic banking and financial activities in Saudi Arabia from the *Shariah* point of view.
4. To determine the legal conflict between the Law of Supervision of Cooperative Insurance Companies and its implementing regulations, in the Kingdom of Saudi Arabia.
5. To suggest solutions to develop a legislative and regulatory framework for Islamic banking and finance in Saudi, in line with the standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) of Islamic finance and also the Malaysian experience.

1.6 Research Questions

The main research question is to what extent Islamic financial contracting forms in Saudi Arabia comply with *Shariah* principles. In addition, there are additional research questions have been carefully selected to suggest reforms to the current uses of Islamic bonds, Islamic insurance and accepted risk transfer mechanisms in Islamic structured finance and also to

propose a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia. They have been determined in accordance with the absence of specific laws governing Islamic banking and financial activities in Saudi Arabia, and also the lack of an independent central *Shariah* board. In order to achieve the research aims, the following research questions will be answered:

1. What are the basic laws for Islamic banking and financial activities including Islamic bonds, Islamic insurance and Islamic derivatives in Saudi Arabia?
2. What are the different Islamic financial contracting forms that are available and what are their specifications and advantages and disadvantages?
3. What is the major difference between conventional and Islamic financial contracting forms?
4. To what extent does the legal framework of the issuance of *sukuk* in Saudi Arabia comply with *Shariah* principles?
5. To what extent do the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations, comply with *Shariah* law?
6. How do Islamic financial derivatives work in Saudi Arabia from the perspective of Islamic *Shariah* Law?

1.7 Research Scope and Limitation

The scope of this research covers the current uses of *sukuk*, the models of *takaful* and accepted risk transfer mechanisms in Islamic structured finance in Saudi Arabia from the perspective of Islamic *Shariah* law. This research analyses whether the current practices of Islamic banking and financial activities in Saudi Arabia are compatible with the principles of *Shariah*. The views of scholars of *Shariah* in the banking and financial issues in this work are limited to the *Sunni* sect or school (*madhhab*).

This research is limited to discussing and analysing three basic laws of banking and financial activities in Saudi Arabia that regulate and supervise Islamic banking and financial activities side-by-side with conventional commercial banking businesses. It is also limited to focusing on three types of key financial institutions that are offering Islamic banking and financial products and services in Saudi Arabia, namely Islamic banks and Islamic windows of conventional banks, cooperative insurance companies and Islamic capital markets.

This research focuses on the SAMA, and the CMA, which are considered the authorities responsible for the regulation and supervision of banking and financial products in Saudi Arabia. However, the focus of this work is on how to transfer the Malaysian experience in the field of Islamic banking and finance to Saudi Arabia, with some modifications that are commensurate with the nature of the Saudi regime. The main reason for choosing Malaysia is that it is considered one of the most advanced Islamic finance industries in the world, particularly in terms of Islamic bonds (*sukuk*) where it is the world's largest *sukuk* market with a number of Malaysia's *sukuk* issues by 68.9%, or USD 62 billion of total global outstanding *sukuk* at the end of 2007.²¹ In addition, Malaysia has issued a number of laws and regulations related to Islamic finance and *takaful* to regulate and supervise IFIs in Malaysia. It has also established the *Shariah* Advisory Council (SAC) as the sole *Shariah* authority for the Islamic banking and *takaful* industries.²²

1.8 Research Methodology

The selected research methods for this research are both a critical literature review and comparative analysis. Thus, the first step in this research will be an in-depth critical literature review to cover Islamic financing contracts as an alternative to conventional loan products. At this stage, the researcher will conduct the review in order to comprehend as much as possible of the published research related to the shortcomings of the conventional economic system from the *Shariah* point of view. The starting point will be reviewing the books, guidelines, and reports to comprehend the procedures, laws, regulations, and the actual practices of Islamic banking and finance. The next step will be reviewing the academic journals which are concerned with contract law, Islamic economic regulations and Islamic finance and banking systems. Such a comprehensive literature review will help the researcher to comprehend the underlying concepts, laws and philosophies of these two different schools, Islamic and conventional. This will also assist him in identifying the strengths and weak points in them in order to have a firm basis for determining, comparing and evaluating the major differences between them.

²¹ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476.

²² Hjh Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer* (2009) 30 (10) 312.

The focus will be on Saudi Arabia's legal structure and the banking and financial systems. At this stage, the researcher's critical literature review will focus on the existing laws and regulations governing Islamic banking and financial activities in Saudi Arabia in order to determine the difficulties, limitations and barriers of applying the Islamic financing contracts system in Saudi Arabia. In addition, the critical literature review will cover the SAMA, and the CMA as the authorities who are responsible for the regulation and supervision of Islamic banking and financial activities in Saudi Arabia, in order to determine the legal challenges that face these activities from the *Shariah* point of view, and to attempt to address them from the perspective of *Shariah*.

The second method is a comparative approach. This approach will be applied in this research to achieve its aims. The comparison will be carried out between the current practices of Islamic banking and financial products in Saudi Arabia and Malaysia. The purpose of this comparison is to explore a legislative and regulatory framework for Islamic banking and financial activities in Saudi Arabia. This will be helpful to build upon and try to take further steps towards transferring the Malaysian experience in the field of Islamic banking and finance to Saudi Arabia with some modifications that are commensurate with the nature of the Saudi regime. The comparison will be vital for identifying the difficulties, limitations and barriers in relation to the existing laws and regulations governing Islamic banking and financial activities in Saudi Arabia.

1.9 Research Structure

This thesis is divided into seven chapters. The first chapter has presented a general introduction to the thesis components. In this chapter, the research significance, research problem, aims, questions, scope and limitation and research methodology are defined and formulated.

The second chapter will provide background information to the Saudi legal structure and the Islamic banking and financial systems in Saudi Arabia. The chapter will give a brief overview of the meaning of *Shariah* and its legal sources, and also the main *Sunni* schools (*madhhab*). It will also discuss the authorities responsible for the regulation and supervision of Islamic banking and financial activities in Saudi Arabia. This chapter will answer research question one.

Chapter Three will use a comparative approach to explain the nature and scope of Islamic finance in comparison with the conventional system. A review of the body of knowledge concerning Islamic finance will be covered in this chapter, including the definition of Islamic finance, its distinguishing features, its main principles, its laws and regulations, and the risks and challenges involved. The chapter will then discuss the differences between Islamic finance and conventional finance. Research questions two and three will be answered in this chapter.

Chapter Four will give a critical analysis of the regulatory framework of the issuance of *sukuk* in Saudi Arabia, and the legal challenges, and provide recommendations to overcome these challenges from the *Shariah* point of view. This chapter will discuss whether the issuance of *sukuk* in Saudi Arabia, which is regulated and supervised by the CMA side-by-side with the issuance of shares and debt instruments under the Offers of Securities Regulations and the Listing Rules, complies with *Shariah* principles. This chapter will discuss the difference between *sukuk* and a conventional bond. Research question four will be answered in this chapter.

Chapter Five will give a comprehensive and critical review of *takaful* applications in Saudi Arabia. This chapter will determine the legal conflict between the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations. The chapter will investigate whether this law and its implementing regulations comply with *Shariah* law or are in need of reform. The chapter will then review the body of knowledge concerning Islamic insurance, its principles, regulation and supervision, challenges and models from the *Shariah* point of view. Finally, this chapter will discuss the difference between *takaful* and conventional insurance, and why conventional insurance is prohibited and unacceptable in *Shariah*. Research question five will be answered in this chapter.

Chapter Six will give a comprehensive and critical review of Islamic derivatives as an alternative to conventional derivatives in Saudi Arabia, and examine whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*. The chapter will then discuss the difference between derivatives in Islamic and conventional finance, and why derivatives in conventional finance are prohibited and unacceptable in *Shariah*. It will also critically analyse how Islamic financial derivatives work in Saudi Arabia from the *Shariah* point of view. At the end of this chapter, the

researcher will propose a legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia.

Chapter Seven will conclude the whole thesis, and make recommendations from the study in order to reform the current systems of Islamic banking and finance in Saudi Arabia. The contributions made by the study and suggestions for future research will be included in this final chapter.

CHAPTER TWO: BACKGROUND TO THE SAUDI LEGAL STRUCTURE AND ISLAMIC BANKING AND FINANCIAL SYSTEMS IN SAUDI ARABIA

2.1 Introduction

The purpose of this chapter is to explain multiple issues that relate to the chapters that follow it. It therefore provides background information to the Saudi legal structure and the Islamic banking and financial systems in Saudi Arabia. Accordingly, there are three sections in this chapter. The first one provides an overview of Saudi Arabia, offering a brief review of the development of Islamic banking and finance there. This section also clarifies exactly what is meant by *Shariah*, explaining the legal sources of *Shariah*, either the primary sources or the secondary sources, and also the main *Sunni* schools (*madhhab*). The next section covers the basic law of governance, and the basic laws of banking and financial activities in Saudi Arabia. The third section illustrates the authorities responsible for the regulation and supervision of Islamic banking and financial activities in Saudi Arabia. A summary is provided at the end.

2.2 Overview of Saudi Arabia

Saudi Arabia is considered the birthplace of Islam and is the home to Islam's two holiest shrines, in Mecca and Medina. Saudi Arabia was established in 1932 by King Abdulaziz. It lies in the south-west of Asia, and comprises an area of 2.25 million sq. km, with a population of around 27 million, including 8.4 million foreign residents. Saudi Arabia is divided administratively into thirteen provinces (*mintaqah*), and each province is governed by a member of the royal family.²³ Islam is the official religion of Saudi Arabia, Arabic is its language, and its capital city is Riyadh. Monarchy is the system of rule in Saudi Arabia;²⁴ the king's official title is Custodian of the Two Holy Mosques, and he fills the roles of both prime minister and head of state.²⁵

The constitution of Saudi Arabia is based on *Shariah* derived from the *Quran* and the *Sunnah*.²⁶ The *Quran* and the *Sunnah* are considered the primary sources of *Shariah*, while Islamic scholarly consensus (*Ijma*) and analogical reasoning by Muslim judges (*Qiyas*) are

²³ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: <http://www.saudiembassy.net/about/country-information/> [Accessed 16 November 2013].

²⁴ Basic Law of Governance 1992, Art. 1, 5 (A) and 5 (B).

²⁵ Ibid.

²⁶ Ibid., Art. 1.

secondary sources. The primary sources of *Shariah* govern all administrative regulations of the State.²⁷ In Saudi Arabia, *Shariah* is interpreted by Islamic judges (*qadis*) who have been influenced by the *Hanbali madhhab* (school) of Islamic jurisprudence which is applied by Saudi courts.²⁸

Under Article 44 of the Basic Law of Governance, the state's authorities consist of a judicial authority, a legislative authority and an executive authority. The King is the ultimate arbiter for these authorities.²⁹ The Saudi judicial authority consists of the *Shariah* courts system, the Board of Grievances and quasi-judicial committees,³⁰ such as the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency (SAMA),³¹ and the Commercial Papers Law, and Anti-Commercial Fraud Law, in the Ministry of Commerce and Industry in Saudi Arabia.³² The source for *fatwa* (religious legal opinion) is derived from *Shariah*, so the courts apply the provisions of *Shariah*, and whatever laws are not in conflict with the *Quran* and the *Sunnah*, to cases before them.³³

The Basic Law of Governance uses the term 'regulatory authority' to cases before them to refer to the Saudi legislative authority because God is the ultimate source of legislation.³⁴ Article 67 of the Basic Law of Governance stipulates that the legislative authority shall have the jurisdiction of formulating laws in accordance with the principles of *Shariah*.³⁵ In fact, the Saudi legislative authority is shared by the King, the Council of Ministers, and the Consultative Council (*Majlis al-Shura*).³⁶ The Basic Law of Governance states that the King presides over the Council of Ministers.³⁷ The *Majlis al-Shura* proposes a draft of a new law or an amendment to an enacted law and studies them within the council, and then the *Shura* council's resolutions are submitted to the king.³⁸ The researcher believes that *Majlis al-Shura* assumes legislative competence in Saudi Arabia because it is considered the sole

²⁷ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 128.

²⁸ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 16.

²⁹ *Ibid.*, Art. 44.

³⁰ *Ibid.*, Art. 51.

³¹ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx>, [Accessed 18 November 2013].

³² See the official website of the Ministry of Commerce and Industry, available at: <http://mci.gov.sa/en/LawsRegulations/Pages/default.aspx>, [Accessed 18 November 2013].

³³ *Ibid.*, Art. 45, 48.

³⁴ *Ibid.*, Art. 44.

³⁵ *Ibid.*, Art. 67.

³⁶ Joseph Kechichian, *Legal and Political Reforms in Saudi Arabia*, (Routledge 2013) 26.

³⁷ *Ibid.*, Art. 65.

³⁸ Shura Council Law 1992, Art. 23.

representative of the Saudi people under Article Two and Article Fifteen of the Shura Council Law.³⁹ However, Article Three of the Shura Council Law stipulates that all members of the Shura Council are chosen by the King, and their rights, duties and affairs shall be determined by a royal order. This means that none of the members of the Shura Council, not even the Speaker, Vice-Speaker, Assistant Speaker or Secretary General are elected by the people of Saudi Arabia.

The Saudi executive branch is concerned with the application of *Shariah* and the preparation of instructions and regulations to ensure that the implementation is issued by the legislature. It consists of the King, the Council of Ministers, local governments, ministry subsidiaries, and other public, independent and quasi-independent agencies.⁴⁰

The researcher believes that it is important to activate the principle of the separation of powers in Saudi Arabia, and the role of the King is to oversee the application of what comes out of the legislative authority. In practice, the King is the ultimate arbiter for all state authorities, and he represents the legislative and executive branches because he is the head of state and also the prime minister of the Council of Ministers.⁴¹

2.3 The Definition of *Shariah*

It is necessary to clarify exactly what is meant by *Shariah* because, as mentioned that Saudi Arabia derives its authority from *Shariah*.⁴² It is a set of provisions and rules that govern every aspect of a Muslim's life.⁴³ Mawil Dien states that *Shariah* is not law, but it covers all aspects of the life of an individual Muslim, whether religious, political or economic, and also covers transactions and laws. Its provisions are derived from the *Quran* and the sayings of the Prophet Muhammad.⁴⁴

In addition, *Shariah* has five differing degrees of provisions, as follows:

“Obligatory (*fard or wajib*) an obligatory duty, the omission of which is punishable”.

“Desirable (*mandub or mustahab*) an action which is rewarded, but the omission of which

³⁹ Ibid., Art. 2 and 15.

⁴⁰ Ibid., Art. 55, 56, 57 (A. B. C) and 69.

⁴¹ Ibid., Art. 44 and 55.

⁴² Ibid., Art. 7.

⁴³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 21; Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 19.

⁴⁴ Mawil Izzi Dien, *Islamic Law: from Historical Foundations to Contemporary Practice* (Edinburgh University Press 2004) 35.

is not punishable”. “Indifferent (*jaiz or mubah*) an action which is permitted and to which the law is indifferent”. “Undesirable (*mukruh*) an action which is disapproved of, but which is not a punishable offence, though its omission is rewarded”. “Forbidden (*haram*) an action which is absolutely forbidden and punishable”.⁴⁵

2.3.1 The Legal Sources of Shariah

Basically Muslims believe that *Shariah* regulates all aspects of life, whether political, social, economic or personal. *Shariah* derives from the *Quran*, the *Hadiths*, the sayings of the righteous *Salaf*, and the jurisprudence of Islamic clerics, and these define the relationship of people to God, to society and to the universe. *Shariah* determines what may be done and what is not permissible. Muslims resort to *Shariah* to settle disputes among Muslims.⁴⁶ The provisions of *Shariah* are derived from several sources, including primary sources or divine sources, and secondary sources or human sources.⁴⁷ Muslims believe that the divine commands were given by the divine revelations to Prophet Mohammed. Therefore, all human activities must be in accordance with these commands.⁴⁸

2.3.1.1 The Primary Sources are the Quran and Sunnah

2.3.1.1.1 The Quran

The *Quran* is the most important source for Muslims. It governs the life of a Muslim in all aspects and is the main source of legislation.⁴⁹

“We have sent down to you the Book (the Quran) as an exposition of everything, a guidance, a mercy, and glad tidings for those who have submitted themselves (to Allâh as Muslims)”.⁵⁰

Allah sent the *Quran* down in the night of Ramadan to the Prophet Mohammed.⁵¹ The *Quran* is also considered to be the main source of structure in the Islamic banking services. It

⁴⁵ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future*, (World Scientific Publishing Co. Ltd 2005) 27.

⁴⁶ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 404; Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 128.

⁴⁷ Mawil Izzi Dien, *Islamic Law from Historical Foundations to Contemporary Practice* (Edinburgh University Press Ltd 2004) 51.

⁴⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 21.

⁴⁹ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd UK 1984) 21.

⁵⁰ See verse 89 of Surah 16 of the Holy Quran.

contains the divine injunctions prohibiting usury and interest, and it defines how to write commercial contracts and requires the signing of contracts to take place before two witnesses.⁵² Allah has mentioned, in *Sura Al- Baqarah*, Verses 282 of the *Quran*, about writing contracts and the witnesses:

“O you who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate”.⁵³

“Get two witnesses out of your own men. And if there are not two men (available), then a man and two women, such as you agree for witnesses, so that if one of them (two women) errs, the other can remind her. And the witnesses should not refuse when they are called (for evidence)”.⁵⁴

The *Quran* is believed by Muslims to be the words of God, who sent it to the Prophet Muhammad. It begins with *Surat Al-Fatihah*, and ends with *Surat An-Nas*. The *Quran* is divided into 114 chapters, and the chapters are further divided into verses (*Ayah*).⁵⁵ It was recorded during the lifetime of the Prophet Muhammed and the prophet explained it to others.⁵⁶

2.3.1.1.2 The *Sunnah*

The *Sunnah* is the second of the primary sources. It was established in Mecca for about 10 years and after that in Medina for 13 years by the Prophet Muhammad.⁵⁷ Allah talks about the Prophet Muhammad in the Holy Book where it says the Messenger of Allah is a good example as he helped and gave unique treatment to everyone, and therefore Muslims should do as he did.⁵⁸ Muslims believe that God taught the Prophet Muhammad through Gabriel,⁵⁹

⁵¹ Ibid., p. 22.

⁵² Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence*, (The Islamic Texts Society 1989) 32-34; Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 384-385.

⁵³ See verse 282 of Surah 2 of the Holy Quran.

⁵⁴ Ibid.

⁵⁵ Niaz A Shah, *Islamic Law and the Law of Armed Conflict: The Conflict in Pakistan* (Routledge 2011) 17.

⁵⁶ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 52.

⁵⁷ John Burton, *The Sources of Islamic Law: Islamic Theories of Abrogation* (Edinburgh University Press 2003) 10.

⁵⁸ See verse 21 of Surah 33 of the Holy Quran.

⁵⁹ See verses 3 and 4 of Surah 53 of the Holy Quran.

thus they accept the *Sunnah*, like the Holy Book (the *Quran*), because the origin is from Allah. The *Quran* states in this regard:

“Whatever the Messenger has given you take; and what he has forbidden you refrain from. And fear Allah; indeed, Allah is severe in penalty”.⁶⁰

The *Sunnah* contains the sayings of the Prophet Muhammad and the speeches he made for multiple purposes and on different occasions.⁶¹ The *Sunnah* is used to explain and interpret the verses of the *Quran* and shows the objectives of the meanings of the *Quran* and of its divine injunctions and prohibitions. In addition, it governs the lives of Muslims in all aspects, including, for example, financial transaction contracts.⁶² Prophet Muhammed said: “It is forbidden for a person to offer to buy anything for which another person has already made an offer”.⁶³ As well as this, Prophet Muhammad forbade the sale of what is not present at the time of contract.⁶⁴

2.3.1.2 The Secondary Sources are *Ijma* and *Qiyas*

2.3.1.2.1 *Ijma*

One of the minor sources of *Shariah* is *Ijma*. It comes after the *Quran* and *Sunnah*, which means that it is the third source of legislation in Islam.⁶⁵ *Ijma* is not a divine revelation like the *Quran* and *Sunnah*, but it is a rational proof.⁶⁶ *Ijma* indicates the consensus of opinion and agreement between Muslim scholars,⁶⁷ which means that *Ijma* is a unanimous agreement, but the problem of *Ijma* is that there is not often a consensus among Muslim scholars.

The concept of *Ijma* is the unanimous consensus of Muslims scholars on a given issue on a particular time, usually as represented by the agreement of the jurists. It has traditionally been

⁶⁰ See verse 7 of Surah 59 of the Holy Quran.

⁶¹ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 28.

⁶² Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 128; Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 45-46.

⁶³ Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society 1989) 427.

⁶⁴ *Ibid.*, pp. 374-376.

⁶⁵ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984,) 64.

⁶⁶ Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society 1989). 228.

⁶⁷ *Ibid.*

recognised as an independent source of *Shariah*, along with the Quran, *Sunnah* and *Qiyas*, by most of the jurists.⁶⁸ In the *Quran* Allah says:

“Those who have responded to their lord and established prayer and whose affair is [determined by] consultation among themselves”.⁶⁹

Prophet Muhammed supported the *Ijma* in the hadith (*Sunnah*): “My community shall never agree on an error”.⁷⁰ Another hadith Prophet said: “I beseeched Almighty God not to bring my community to the point of agreeing on error and he granted me this”.⁷¹

2.3.1.2.2 *Qiyas*

Qiyas means comparing one thing with another similar thing. a comparison between two things. It started during the lifetime of Prophet Muhammed and it still continues.⁷²

“*Qiyas* is obtained through the legal and philosophical method of analogy, whereby a divine law revealed for a particular situation is applied to another, where some common feature exists in both situations”.⁷³

The concept of the *Qiyas* is derivation of the law on the analogy of an existing law if the basis/rationale of the two are the same. It is considered one of the tools of *ijtihad* and sources of Islamic jurisprudence.⁷⁴

In addition, there are other sources of *Shariah*, such as *Ijtihad* (Self-exertion), *Urf* (Custom), *Istislah* (Public interest), *Istishab* (Legal presumption) and *Istihsan* (Something preferable). These previous sources are for personal interpretation to avoid the stagnation and injustice that might result from the literal application of *Shariah*.⁷⁵

Overall, the differing views have contributed to the development of Islamic jurisprudence so that it may be prepared to face any new events, either currently or in the future. For example, Islamic banking services which are derived from provisions of *Shariah* are major sources and

⁶⁸ Mawil Izzi Dien, *Islamic Law from Historical Foundations to Contemporary Practice* (Edinburgh University Press Ltd 2004) 46; Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 64.

⁶⁹ See verse 38 of Surah 42 of the Holy Quran.

⁷⁰ Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society 1989) 240.

⁷¹ Ibid.

⁷² Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 70-71.

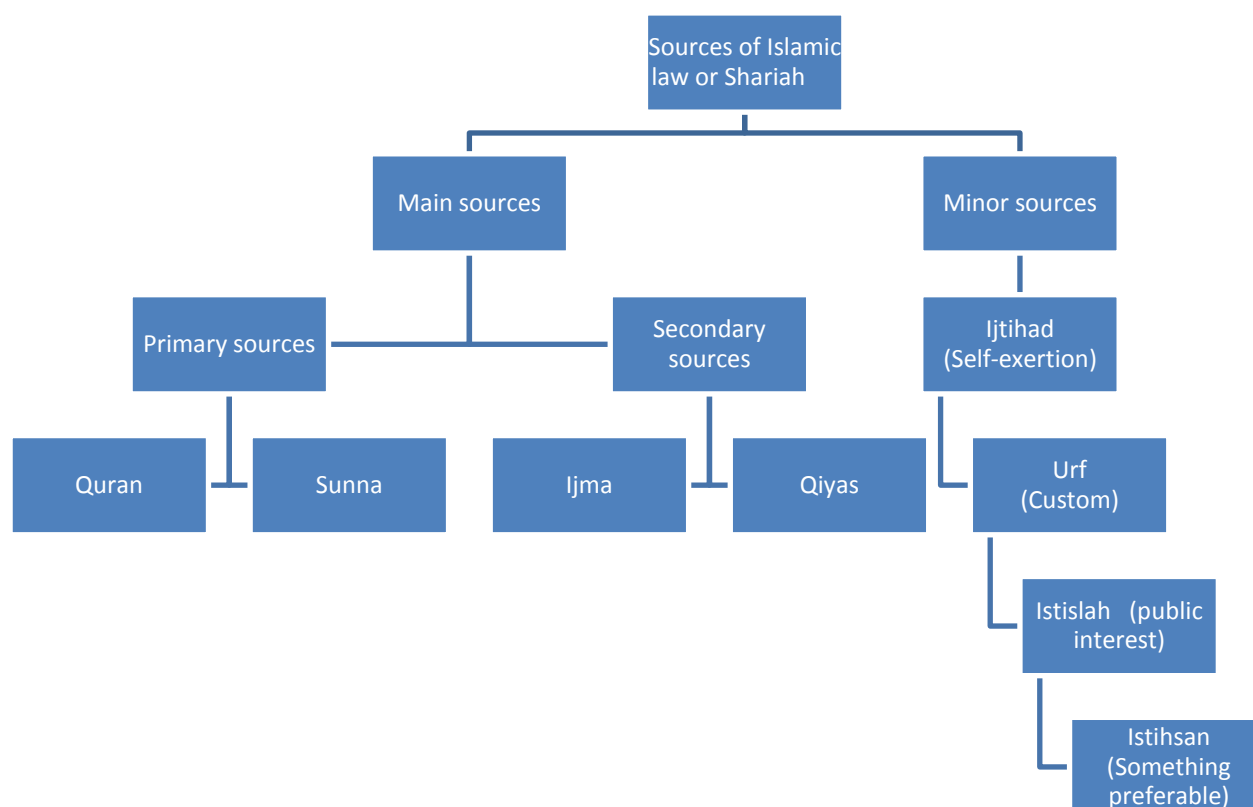
⁷³ Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 1.

⁷⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 22.

⁷⁵ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 81-84.

secondary sources, as well as Islamic financing contracts which are all items subject to the provisions of Islamic *Shariah*.⁷⁶

Figure 1.1: Overview of the sources of *Shariah*



Source: A Primer on Islamic Finance (2009).

2.3.2 Islamic Schools (madhhab)

Prophet Muhammed spent about 13 years in Medina explaining Islam to people, so during his lifetime people did not need to ask anyone else about the teachings of Islam because the prophet was the owner of religious authority and he was receiving the divine commands of Allah.⁷⁷

The Sunni schools of Islamic jurisprudence emerged at the beginning of Islam, especially after the death of the Prophet Muhammed in 632.⁷⁸ The main reasons were the spread of

⁷⁶ Hij Siti Faridah Abd Jabbar, 'The Shari'a Supervisory Board: a potential problem in Islamic finance', *Company Lawyer* (2008) 29 (1) 29-30.

⁷⁷ John Burton, *The Sources of Islamic Law: Islamic Theories of Abrogation* (Edinburgh University Press 2003) 10.

⁷⁸ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing Co. Ltd 2005) 28.

Islam and exposure to many new issues, religious and legislative. In addition, due to the historical circumstances which were being faced at the time of the beginning of the Islamic era, there was an urgent need to resolve emerging issues and to meet the emerging needs of the people and answer their questions; hence a group of scholars was formed, and they taught people.⁷⁹

In Islam, there are four Sunni schools of jurisprudence, called *madhhab*.⁸⁰ Each of these schools derives its provisions from the evidence of the primary sources, which are the *Quran* and *Sunnah*, in accordance with the rules and principles of Islamic jurisprudence. Generally, there is agreement among the scholars of the Islamic faith and the primary sources. However, there are slightly different views among them in the secondary sources, but these are generally accepted as valid from an Islamic point of view.⁸¹ The four schools of Islamic jurisprudence spread widely among Sunnis and became official. The books represent jurisprudence and are attributed to the four Imams of the Sunnis, who were (in historical order): Imam Abu Hanifa, Imam Malik ibn Anas al-Maliki, Imam Muhammad ibn Idris al-Shafi'i and Imam Ahmad ibn Hanbal.

2.3.2.1 The Hanafi School (690 –760)

The Hanafi School is one of the Islamic schools (*madhhab*). It is the oldest school and also the most flexible. It derives its name from the founder of the school, Abu Hanifa an-Nu'man ibn Thābit, known as Abu Hanifa. The doctrine of Imam Abu Hanifa was established in Baghdad, Iraq. The Hanafi school of thought derives its jurisprudence primarily from the *Quran*; however, when absolute jurisprudence cannot be derived from the *Quran*, the Hanafi school of thought looks to other distinguished sources such as the *Sunnah* to support its ruling. Where a ruling remains deficient, secondary sources such as *Ijma* (consensus), *Qiyas* (analogy), *ijtihad* (Self-exertion), *Urf* (Custom) and *Istihsan* (Something preferable) are utilised.⁸² The Hanafi School has become well established in India, Iraq, Egypt, the Levant, Morocco, Turkey, Pakistan, Afghanistan and Bangladesh. After Abu Hanifa's death in 760, his legal views were preserved by Abu Yusuf and Muhammad al-Shaybani.⁸³

⁷⁹ Ibid, p. 31.

⁸⁰ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 15.

⁸¹ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 85.

⁸² Ibid., pp. 88-92.

⁸³ Wael Hallaq, *An Introduction to Islamic Law* (Cambridge University Press 2009) 37.

2.3.2.2 The Maliki School (711–795)

The Maliki School is the second of the four Islamic schools followed by Sunni Muslims to this day.⁸⁴ It was founded in Medina by Malik ibn Anas, who died in 795. His full name is Malik ibn Anas ibn Malik ibn Abi Amir al-Asbahi al-Yamani. He was completely sincere in his quest for knowledge and this made him one of the greatest scholars of Fiqh in the Sunni Islamic world.⁸⁵ The Maliki School is similar to the other Schools in the fundamental principles of Fiqh, except that the *Qiyas* was given priority over the weak *Sunnah* (Hadith) by Imam Malik.⁸⁶ The Maliki Madhab is concentrated in Dubai and Abu Dhabi, Bahrain, Kuwait, Libya, Mauritania, Algeria and Tunisia.⁸⁷

2.3.2.3 The Shafii School (767–820)

The Shafii School is the third Sunni school. It derives its name from Imam Shafii who was born in 767 in Ghazza, the same year that Imam Abu Hanifa died.⁸⁸ The full name of the founder of this School is Muhammed ibn Idris ash-Shafii.⁸⁹ The principles of Imam Shafii have been primarily derived from the *Quran*, the sayings of the Prophet Muhammed and the secondary sources which are *Ijma* “consensus” and the *Qiyas* “analogy”. Imam Shafii rejected *Istislah*, *Istihsan* and *Ijtihad*, preferring *Ijma*.⁹⁰ The Shafii School comes second only to the Hanafi School in terms of followers; it is followed by approximately 29% of the Muslims in the world.⁹¹ There are many countries which follow the Shafii madhhab, such as Malaysia, Indonesia, Egypt, Ethiopia, Sudan, Yemen and Somalia.⁹² Imam Shafii died in 820 in Egypt.⁹³

2.3.2.4 The Hanbali School (781–855)

The Hanbali School is the last of the Sunni schools. This *madhhab* was founded by Imam Ahmad bin Hanbal, who learned from Imam Shafii, and their schools were very similar.⁹⁴

⁸⁴ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010) 78.

⁸⁵ Ibid, p. 79.

⁸⁶ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 15.

⁸⁷ Ibid, p. 16.

⁸⁸ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 103.

⁸⁹ Noel Coulson, *A History of Islamic Law* (Edinburgh University Press 2001) 53.

⁹⁰ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 16.

⁹¹ Ibid.

⁹² Ibid.

⁹³ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 106.

⁹⁴ Ibid., p. 108.

The principles of the Hanbali School were the *Quran*, *Sunnah*, *Ijma* and *Qiyas*. Imam Ahmad had a different point of view from the other schools over the *Qiyas*, because he would consider the *Qiyas* in case of necessity. He also accepted the sayings of a single Companion. Imam Ahmad supported *Ijtihad*, but he rejected the opinions of other scholars (*Taqlid*). The Hanbali School is the most conformist of the four schools; however it is also the most flexible in most commercial issues. Hanbali spread in Saudi Arabia and Qatar, and the Hanbali *madhhab* is applied by the Saudi courts.⁹⁵

At the end of this section on Islamic schools, it is important to mention the opinion of the four Imams about the prohibition of *riba*. All of the Muslim jurists agree that *riba* is prohibited by the *Quran* and *Sunnah*, whether as payment or receipt. The prohibition of interest is considered the most distinctive feature in Islamic economics.⁹⁶

2.4 Basic Law of Governance

The Basic Law of Governance was introduced in 1992 by Royal Order No: A/90 dated 1 March 1992, when King Fahd approved the reform of the constitutional law.⁹⁷ It is deemed the most important constitutional document of legislation for the Council of Ministers Law, the Consultative Council Law and the Regional Law.⁹⁸ The Basic Law of Governance is divided into nine chapters, consisting of 83 articles to identify the nature, objectives and responsibilities of the state, as well as the relationship between the ruler and citizens.⁹⁹ Article 1 of the Basic Law of Governance defines the Kingdom of Saudi Arabia as a fully sovereign Arab Islamic State; its religion is Islam and its constitution is the *Quran* and the *Sunnah*.¹⁰⁰ Article 7 reaffirms that the government derives its authority from the *Quran* and the *Sunnah*, both of which govern all administrative regulations of the state.¹⁰¹ The Basic

⁹⁵ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 16.

⁹⁶ Emad H Khalil, 'An overview of the Sharia'a prohibition of *riba*' in Abdulkader Thomas (ed), *Interest in Islamic Economics: Understanding *riba** (Routledge 2006) 53.

⁹⁷ See the official website of the Bureau of Experts at the Council of Ministers, available at: <http://www.boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>, [Accessed 19 November 2013].

⁹⁸ The Council of Ministers Law, Royal Order, No. A-13, dated 20 August 1993. The Consultative Council Law, Royal Order, No. A-91, dated 1 March 1992. The Regional Law, Royal Order, No. A-92, dated 1 March 1992.

⁹⁹ See the official website of the Bureau of Experts at the Council of Ministers, available at: <http://www.boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>, [Accessed 19 November 2013].

¹⁰⁰ Ibid., Art. 1.

¹⁰¹ Ibid., Art. 7.

Law confirms that the state's role is to protect the principles of Islam and to enforce its *Shariah*.¹⁰²

The Basic Law of Governance emphasizes the principles of consultation, justice, and the equality of citizens in accordance with *Shariah*.¹⁰³ It confirms the basic features of the Saudi family and the importance of Islamic values, justice, and the unity of the family.¹⁰⁴ In addition, the Basic Law confirms that the State must protect human rights in accordance with *Shariah*, provide security to all its citizens and residents, and guarantee the protection of individual freedom from arbitrary arrest and punishment, except under the provisions of the Law.¹⁰⁵ The Basic System obliges the State to provide health care to every citizen, and also to guarantee the rights of the citizen and his family in emergencies, sickness, disability, and old age.¹⁰⁶ The State must facilitate the provision of job opportunities to every able person, and enact laws that protect the worker and the employer.¹⁰⁷

The Basic Law of Governance covers economic affairs in 9 articles. Article 14 defines the means of exploiting, protecting, and developing such wealth in the interests of the state, its security and economy. This article makes it clear that the government owns all natural resources. The State must guarantee the protection of private property, and the maintenance of public money. The Basic System obliges the State to take tax (*zakat*) from the rich and pay it to legitimate recipients.¹⁰⁸

Hasan argues that Saudi Arabia does not have a modern written constitution but firmly adheres to the *Quran* and the *Sunnah* as a legal constitution.¹⁰⁹ Article 1 of the Basic Law of Governance supports this argument which emphasises that the Kingdom of Saudi Arabia is a fully sovereign Arab Islamic State. Its religion is Islam and the Book of God and the *Sunnah* (Traditions) of His Messenger are its constitution.¹¹⁰

However, after the Gulf War, King Fahd wanted to establish a system as a constitution to regulate the state authorities and identify how to transfer power between the sons of King

¹⁰² Ibid., Art. 23.

¹⁰³ Ibid., Art. 8.

¹⁰⁴ Ibid., Art. 9.

¹⁰⁵ Ibid., Art. 26 and 36.

¹⁰⁶ Ibid., Art. 27 and 31.

¹⁰⁷ Ibid., Art. 28.

¹⁰⁸ Ibid., Art. 14, 16, 17, 18 and 21.

¹⁰⁹ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 89.

¹¹⁰ Ibid., Art. 1.

AbdulAziz and the sons of his sons, and in addition, to protect fundamental human rights in accordance with *Shariah*.¹¹¹ Therefore, King Fahd issued Royal Order No: A/90 dated 1 March 1992 to fill a legal gap through the Basic Law of Governance.¹¹² This means that before this Royal Order there was not a written constitution in Saudi Arabia.

Hence, it can be said that there is a modern written constitution in Saudi Arabia, namely the Basic Law of Governance issued in 1992, and this written constitution is based on the *Quran* and the *Sunnah*. Therefore, there should be no conflict between the Basic Law of Governance as the Saudi constitutional law and the principal sources of *Shariah*, which are the *Quran* and the *Sunnah*.¹¹³

2.5 Basic Laws of Banking and Financial Activities in Saudi Arabia

The history of banking systems in Saudi Arabia began in the 20th century with the first commercial bank, under the name of the Dutch Commercial Company, which was established in 1926.¹¹⁴ Currently, there are 12 Saudi banks,¹¹⁵ and 11 branches of foreign banks that have been licensed by the Saudi Arabian Monetary Agency (SAMA) to offer investment services, retail and corporate banking, brokerage facilities and derivative transactions, in addition to credit cards, ATMs and point-of-sale transactions. Four of these banks are Islamic banks, providing Islamic banking and financial services in accordance with the principles of *Shariah*.¹¹⁶

In addition, there is also the Saudi Stock Exchange (*Tadawul*), which is considered one of the most highly capitalised stock exchanges in the Arab world.¹¹⁷ The issuance of *sukuk* in Saudi

¹¹¹ Ibid., Art. 5 (B), 26 and 44.

¹¹² See the Official Website of the Bureau of Experts at the Council of Ministers, available at: <http://www.boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>, [Accessed 19 November 2013].

¹¹³ Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (Unpublished PhD Thesis, Brunel University 2013) 14-15.

¹¹⁴ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 96.

¹¹⁵ Al Rajhi Bank, Bank AlBilad, alinma bank, Bank AlJazira, Riyad Bank, The National Commercial Bank, Saudi Hollandi Bank, Arab National Bank, Banque Saudi Fransi, The Saudi British Bank, Saudi Investment Bank, and Samba Financial Group (Samba). See to the Saudi Arabian Monetary Agency (SAMA).

¹¹⁶ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx, [Accessed 26 November 2013].

¹¹⁷ See the official website of the Royal Embassy of Saudi Arabia in Washington, available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx, [Accessed 26 November 2013].

Arabia is traded on the Saudi Stock Exchange, and regulated and supervised by the Offer of Securities Regulations issued by the Capital Markets Authority (CMA).¹¹⁸

With respect to the insurance industry in Saudi Arabia, Saudi Arabia's *takaful* insurance industry is considered the largest *takaful* industry in the world. In 2011, Gross Written Premiums (GWP) in the Saudi insurance market reached SR 18.504 billion, up from SR 16.387 billion in 2010.¹¹⁹ The Saudi Arabian insurance industry is regulated and supervised by the Saudi Arabian Monetary Agency under the Cooperative Insurance Companies Control Law which was issued by Royal Decree No. M/32 on 01/08/2003.¹²⁰

2.5.1 The Banking Control Law (BCL)

The Banking Control Law (BCL), issued under Royal Decree No. M/5 dated 11/6/1966, is considered the main legislation to regulate all banking and financial services in Saudi Arabia.¹²¹ This law gives SAMA broad powers to regulate and supervise Saudi banks and to safeguard the banking system.¹²² For example, Article 3 of the BCL stipulates that all applications to carry on a banking business in Saudi Arabia shall be addressed to SAMA.¹²³

The BCL defines the banking business, confers licensing powers, and determines capital adequacy, opening of current accounts, opening of letters of credit, issuance of letters of guarantee, payment and collection of cheques, payment orders, promissory notes and similar other papers of value, discounting of bills, bills of exchange and other commercial papers, foreign exchange transactions and other banking business.¹²⁴

The BCL does not provide a specific framework for the Islamic banking and financial services in its 26 articles. The Islamic banking and financial services are regulated and supervised side by side with conventional banking by SAMA under the BCL of 1966.¹²⁵ According to Hasan, in Saudi Arabia, the Islamic financial institutions (IFIs) operate under a

¹¹⁸ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/CME/Pages/default.aspx>, [Accessed 26 November 2013].

¹¹⁹ Saudi Arabian Monetary Agency, 'Insurance Supervision Department', The Saudi Insurance Market Report 2011, <http://www.sama.gov.sa/sites/samaen/Insurance/InsuranceLib/SUR_InsuaMarketSurvey2011_En_2011> [Accessed 18 May 2013].

¹²⁰ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFuction.aspx>, [Accessed 26 November 2013].

¹²¹ Ibid.

¹²² Ibid.

¹²³ Ibid.

¹²⁴ Ibid.

¹²⁵ Ibid.

strange legal framework because the legal system of Saudi Arabia is actually based on *Shariah* whereas the existing law of the Banking System 1966 is still applicable and it has not been amended or repealed to regulate the establishment and the existence of the IFIs.¹²⁶

2.5.2 The Capital Market Law (CML)

The Capital Market Law (CML) was issued by Royal Decree No. M/30, dated 31/07/2003, to regulate and develop the Saudi financial market through improving the development of procedures that would reduce the risks related to securities transactions.¹²⁷ The CML gives the Capital Market Authority (CMA) broad powers to regulate the issuance of securities, as well as to monitor them and dealings in them.¹²⁸ In addition, the CML protects citizens and investors in Securities from unfair and unsound practices or practices involving fraud, deceit, cheating or manipulation.¹²⁹ The CML seeks to achieve transparency, fairness and efficiency in Securities transactions.¹³⁰

The CML does not provide a specific framework for the issuance of *sukuk* in its articles. Moreover, the CML does not include any mention of *Shariah*, knowing that the basic system in Saudi Arabia is derived from *Shariah*. Currently, the issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA under the CML.¹³¹ According to Al Elsheikh, the absence of the legal framework for the issuance of *sukuk* in Saudi Arabia could generate confusion between *sukuk*, shares, bonds and conventional debt instruments.¹³²

2.5.3 The Law of Supervision of Cooperative Insurance Companies

The Cooperative Insurance Companies Control Law was approved by Royal Decree no. M/32 dated 01/08/2003, which set the stage for the legal framework of the cooperative insurance companies sector in Saudi Arabia.¹³³ Subsequently, its implementing regulations

¹²⁶ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 96.

¹²⁷ The Capital Market Law 2003, Art. 5 (A-1).

¹²⁸ Ibid., Art. 5 (A-2).

¹²⁹ Ibid., Art. 5 (A-4).

¹³⁰ Ibid., Art. 5 (A-5).

¹³¹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

¹³² Ibid.

¹³³ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/SAMAEN/Insurance/Pages/LawsandRegulations.aspx>, [Accessed 30 November 2013].

were issued by Ministerial Decision No. 1/596 dated 20/04/2004, to regulate the insurance sector.¹³⁴

The cooperative insurance law and its implementing regulations gave SAMA wide-ranging powers, such as the licensing of insurance companies and insurance professionals, the regulation and supervision of the insurance sector, and the policing and control of the Saudi insurance market.¹³⁵ Therefore, SAMA is considered the regulatory authority for the cooperative insurance companies sector in Saudi Arabia.

The objectives of the law and its implementing regulations are the protection of policyholders and shareholders, enhancing the stability of the insurance market, and encouraging fair and effective competition in the insurance sector in Saudi Arabia under Article 2 of the implementing regulations.¹³⁶

2.6 Authorities responsible for the regulation and supervision of Islamic Banking and Financial Activities in Saudi Arabia

In Saudi Arabia, there are two authorities responsible for the regulation and supervision of Islamic banking and financial activities, cooperative insurance (*takaful*), and Islamic *sukuk*. These authorities are the Saudi Arabian Monetary Agency (SAMA), and the Capital Market Authority (CMA).

2.6.1 The Saudi Arabian Monetary Agency (SAMA)

The SAMA was established under two Royal Decrees, No. 30/4/1/1046 and No. 30/4/1/1047, on 4 October 1952 as the central bank of Saudi Arabia.¹³⁷ It is governed by a board of directors, which is headed by a Governor, Deputy Governor, and three members, appointed by the King under a Royal Decree for terms of 4 years.¹³⁸ The first Board of Directors of SAMA was formed in 05/08/1952 under Royal Decree No. 30/4/1/1744, and the first

¹³⁴ Ibid.

¹³⁵ Ibid.

¹³⁶ Implementing Regulations 2004, Art. 2.

¹³⁷ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAHistory.aspx>, [Accessed 1 December 2013].

¹³⁸ Mohamed Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (Springer 2010) 76.

governor of SAMA was George A. Blowers (a U.S. citizen) in 05/08/1952 under Royal Decree No. 30/4/1/1743.¹³⁹

Unlike in Malaysia,¹⁴⁰ there is no independent central *Shariah* board in Saudi Arabia to regulate and supervise Islamic banking and financial activities. Currently, SAMA regulates and supervises Islamic financial institutions (IFIs) that conduct banking and financial activities side-by-side with conventional commercial banking businesses under the BCL of 1966.¹⁴¹ It also regulates and supervises the cooperative insurance companies sector under the Law of Supervision of Cooperative Insurance Companies of 2003, and its implementing regulations of 2004.¹⁴²

Article 1 of the Charter of SAMA stipulates that one of the objectives of SAMA is to regulate commercial banks and exchange dealers.¹⁴³ The Charter does not mention Islamic banks or IFIs in its Articles. It is known that the Islamic financial industry was established in 1963,¹⁴⁴ while the Charter was issued by a Royal Decree No.23 dated 15/12/1957,¹⁴⁵ which means that the Charter was established before the start of the Islamic financial industry. However, it was assumed that the Saudi government took into account Islamic banks, and Islamic banking and financial services, when it issued the Banking Control Law on 11/6/1966.

There are a number of important functions of SAMA as the central bank of the Kingdom of Saudi Arabia. These functions include minting and issuing the national currency (the Saudi Riyal), in addition to strengthening the currency's cover; supervising commercial banks and exchange dealers including IFIs; supervising cooperative insurance companies and the self-employment professions relating to insurance activity; supervising finance companies; supervising credit information companies; managing the Kingdom's foreign exchange reserves; promoting the growth of the financial system and ensuring its soundness; operating

¹³⁹ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAHistory.aspx>, [Accessed 1 December 2013].

¹⁴⁰ In Malaysia, the Shariah Advisory Council (SAC) regulates and supervises Islamic banking activities. SAC is the highest *Shariah* authority in Islamic finance, responsible for validating all Islamic financial products to ensure their compatibility with *Shariah* principles. See too the official website of Bank Negara Malaysia (BNM).

¹⁴¹ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, [Accessed 30 November 2013].

¹⁴² Ibid.

¹⁴³ Charter of the Saudi Arabian Monetary Agency (SAMA) 1957, Art. 1.

¹⁴⁴ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 401.

¹⁴⁵ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>, [Accessed 1 December 2013].

a number of cross-bank electronic financial systems such as *tadawul*, SPAN, SARIE, MAQASA and SADAD.¹⁴⁶

2.6.2 The Capital Market Authority (CMA)

The CMA was established under Article 4 of the CML, issued by Royal Decree No. M/30 dated 2 July 2003, to regulate and develop the capital markets activities in Saudi Arabia. The CMA is as an independent authority directly linked with the Prime Minister, and it has financial and administrative autonomy. It is governed by a board of five full-time members appointed by the King under Royal Decree.¹⁴⁷

The functions of the CMA are to regulate and develop the Saudi Capital Market by issuing the required regulations and rules for implementing the provisions of CML. In addition, the CMA regulates the issuance of Securities and monitors Securities and dealing in Securities including the issuance of *sukuk*. It also regulates and monitors the work and activities of parties subject to the control and supervision of the Authority.¹⁴⁸

The basic objectives of the CMA are to create an appropriate investment environment through issuing required rules and regulations, reinforcing the transparency and disclosure standards of all listed companies, boosting confidence, and protecting investors and dealers from illegal acts in the market.¹⁴⁹ The CMA is empowered under Article 5 of the CML to issue the required rules and regulations to create a conducive environment for the growth of investment activities in Saudi Arabia.¹⁵⁰

2.7 Summary

This chapter provided background information to the Saudi legal structure and Islamic banking and financial systems in Saudi Arabia. The chapter clarified exactly what is meant by *Shariah* as a constitution of Saudi Arabia, including the legal sources of *Shariah*, both the

¹⁴⁶ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFFunction.aspx>, [Accessed 2 December 2013].

¹⁴⁷ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/CH2Article4.aspx>, [Accessed 2 December 2013].

¹⁴⁸ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/Ch2Article5.aspx>, [Accessed 2 December 2013].

¹⁴⁹ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx>, [Accessed 2 December 2013].

¹⁵⁰ Kabir Hassan and Mervyn Lewis & Michael Mahlke, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 102.

primary sources such the *Quran* and *Sunnah* and the secondary sources such as *Ijma* and *Qiyas*. This section also covered the main *Sunni* schools (*madhhab*): the Hanafi School, the Maliki School, the Shafii School, and the Hanbali School which is applied by Saudi courts.

This chapter covered the basic law of governance, and the basic laws of banking and financial activities in Saudi Arabia, such as the BCL, the CML, and the Law of Supervision of Cooperative Insurance Companies. Under these laws, SAMA regulates and supervises Islamic financial institutions that conduct banking and financial activities side-by-side with conventional commercial banking businesses. It also regulates and supervises the cooperative insurance companies sector in Saudi Arabia. In addition, the CMA regulates the issuance of Securities and monitors Securities and dealing in Securities including the issuance of *sukuk*. The next chapter will focus on explaining the nature and scope of Islamic finance, by giving an overview of its laws and practices.

CHAPTER THREE: AN OVERVIEW OF ISLAMIC FINANCE: LAW AND PRACTICE

3.1 Introduction

This chapter focuses on explaining the nature and scope of Islamic finance, while subsequent chapters will examine other systems, using a comparative approach. Islamic finance has experienced substantial and unexpected growth in recent years: ¹⁵¹ it is growing at a rate of 15% per year.¹⁵² Currently, the circulating assets of Islamic finance are estimated to be the equivalent of US \$ 1.4 trillion.¹⁵³ There are more than 500 Islamic financial institutions operating in over 75 countries,¹⁵⁴ including Western countries,¹⁵⁵ which means it is one of the fastest growing financial sectors in the world, particularly in the Gulf Cooperation Council countries, due to the oil boom.¹⁵⁶

Islamic finance is a set of financial activities providing many tools and modes of financing and investment methods which have become an important part of global banking, and meet the needs of customers as they are compliant with *Shariah*.¹⁵⁷ Islamic finance offers several products and financial activities that are compliant with *Shariah*, such as *Mudaraba*, *Musharaka*, *Murabaha*, *Ijara*, *Bai' bithaman*, *Ajil*, *Bai' salam*, *Istisna'*, *Qardh-al-hasan* and *Tawarruq*.¹⁵⁸ Islamic finance promotes the sharing of risks and profits between parties based on the purchase and sale of tangible assets such as real estate, known as *Murabaha*, which means that Islamic finance not only concentrates on the benefits, but provides banking services and the practice of finance and investment on the basis of prohibitions of interest (*riba*) in all transactions, as well as socio-economic justice.¹⁵⁹

In addition, Islamic banks and Islamic financial institutions (IFIs) have kept pace with modern technological developments, providing distinguished banking services and

¹⁵¹ Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 680.

¹⁵² Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 126.

¹⁵³ Yoko Ishigaki, 'The development of the Islamic financial market-the Tokyo sukuk case study', *Company Lawyer* (2009) 30 (5) 2.

¹⁵⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 15.

¹⁵⁵ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 1.

¹⁵⁶ Yoko Ishigaki, 'The development of the Islamic financial market – the Tokyo sukuk case study', *Company Lawyer* (2009) 30 (5) 3.

¹⁵⁷ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 1-2.

¹⁵⁸ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (6) 1.

¹⁵⁹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 27.

developing methods and banking practices using the latest technology available in the world.¹⁶⁰

3.2 An Overview of Islamic Finance

Islamic finance is based on *Shariah*, which is derived from the Holy Book (*Quran*), the sayings of the prophet Muhammed (*Sunnah*), the consensus among Muslim scholars (*Ijma*) and analogy (*Qiyas*).¹⁶¹ With the growth of Islam in the world, a need for financial contracts governed by *Shariah* has emerged;¹⁶² therefore, Islamic financing is growing in many places around the world, such as the Middle East, Southern Africa and East Asia. There are some countries which have fully Islamic banking systems, such as Sudan and Pakistan, while there are other countries, such as Indonesia, Bahrain, Turkey, Jordan, Egypt and Malaysia, which operate mixed systems; for instance, having both Islamic and western banking systems together.¹⁶³ Malaysia is considered the leading country in the area of Islamic finance. However, , in that country, Islamic banks operate side by side with conventional banks, and in the view of some researchers there is no significant difference between Islamic and conventional banking systems. This will be discussed later.¹⁶⁴ The purpose of Islamic finance is to provide methods and forms of finance which conform to *Shariah*: “Islamic finance denotes financial activities that are compliant with *Shariah*”.¹⁶⁵ Therefore, any activities not compatible with the provisions of *Shariah* are forbidden for Muslims.¹⁶⁶ In the *Quran*, Allah mentions this in *Surat An-Nisa*, Verse No. 29:

“O you who believe, consume not your goods between you wrongly, unlawfully according to the Law, through usury or usurpation, except it be trading (tijāratun, also read tijāratun), so that the goods be from trade effected, through mutual agreement, through mutual good-will: such [goods] you may consume. And kill not yourselves, by committing what leads towards destruction on account of some affiliation, be it in

¹⁶⁰ Mohammad Salim AL-Rawashdah, ‘The political and financial implications of globalization on the Islamic banking: facts and events’, *European Journal of Social Sciences* (2009) 12 (2) 192.

¹⁶¹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 41; Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (6) 2.

¹⁶² Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (6) 1.

¹⁶³ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 95.

¹⁶⁴ Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 126-130.

¹⁶⁵ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (6) 23.

¹⁶⁶ Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 128.

this world or the Hereafter. Surely God is ever Merciful to you, when He forbids you such things”¹⁶⁷.

However, Islamic finance is not confined only to Muslims, but is in the interests of the community as a whole. It is also not restricted to particular countries, but has spread in the world to include the Western world and especially in Europe such as in Switzerland, Luxembourg and Denmark, but the UK is the only European country where Islamic banking has become widely used.¹⁶⁸ In 2008, there were more than 25 Islamic organisations offering Islamic products compliant with *Shariah* in the United Kingdom (UK). The UK is well on its way to becoming the largest Islamic financial centre.¹⁶⁹

Islamic finance is expanding outside Muslims countries to some non-Muslim countries around the world, some of which have granted Islamic banks licences to establish activities which comply with *Shariah*, and the United Kingdom is at the forefront. For instance ‘in August 2004, the United Kingdom’s Financial Services Authority (FSA) approved a banking license for the Islamic Bank of Britain (IBB), the country’s first Islamic bank’.¹⁷⁰ The first Islamic financial institution in Western countries was established in 1978 in Luxembourg. Nowadays, it is known as the Islamic Finance House.¹⁷¹

3.3 The Definition of Islamic Finance

Islamic finance has been defined and described by a number of researchers. According to Greuning and Iqbal, the Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return.¹⁷² This definition is very narrow because it focuses on the religious side more than other considerations such as economic and investment aspects. Islamic finance has become an international industry and has operated side by side with conventional banks either in Muslim or non-Muslim countries. In addition, Islamic finance includes more than banking, such as insurance companies, securities firms and mutual funds. Therefore, Islamic finance was not founded just to prohibit *riba*, but to offer Islamic alternatives to customers who wanted to receive them, whether they

¹⁶⁷ See verse 29 of Surah 4 of the Holy Quran.

¹⁶⁸ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 95.

¹⁶⁹ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009). 9.

¹⁷⁰ V Subbulakshmi, *Islamic Finance: Regulatory Perspectives* (ICFAI University Press 2004) 18.

¹⁷¹ Mohamed Ariff, *Islamic Banking: Islam and the Economic Development of Southeast Asia* (Institute of Southeast Asian Studies 1988) 43.

¹⁷² Hennie Van Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 5.

were Muslims or non-Muslims, and currently it has become a financial industry that competes globally.

Another definition, by Andreas Jobst, states that 'Islamic finance is limited to financial relationships involving entrepreneurial investment subject to the moral prohibition of interest earnings or usury (*riba*) and money lending'.¹⁷³ This definition focuses on the relationship between the Islamic financial institutions (IFIs) and their customers, as well as on the prohibition of *riba* and lending. In addition to the religious aspects, there are several other important aspects, such as ethical and social aspects. Therefore, the prohibition of *riba*, money lending and the relationship between the institutions and their clients in Islamic finance are important, but the ultimate objective of Islamic finance is to enhance social justice and promotion of human welfare through a strong emphasis on the ethical and moral dimensions.¹⁷⁴

Siddiqui defines Islamic finance as being based on the principles that exclude interest (*riba*), do not possess major uncertainty (*gharar*) and do not have gambling-like features (*maysir*).¹⁷⁵ This definition focuses only on three principles of Islamic finance, while a unique feature of Islamic finance is profit-and-loss sharing (PLS).¹⁷⁶

The definition of Islamic finance adopted in this thesis is the one provided by Abd Jabbar, where he says that Islamic finance refers to the provision of financial services on a basis that is compliant with *Shariah*, or more specifically, with the principles and rules of Islamic commercial jurisprudence known as *fiqh al-muamalat*.¹⁷⁷ This definition focuses on the legal aspects more than others. In addition, it determines the principles and rules of Islamic finance in general, while the previously mentioned definitions focus on specific principles such as the prohibition of *riba*, *gharar* and *maysir*.

¹⁷³ Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization', *International Monetary Fund* (2007) 117 (7) 4.

¹⁷⁴ Anas Elmelki & Mounira Ben Arab, 'Ethical Investment and the Social Responsibilities of the Islamic Banks', *International Business Research* (2009) 2 (2) 129.

¹⁷⁵ Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 681.

¹⁷⁶ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 126.

¹⁷⁷ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions', *Company Lawyer* (2009) 30 (1) 24.

3.4 The Beginning of Islamic Finance Contracts

Muslims have been looking for permissible means through *Shariah* on finance and investment because they do not wish to deal with prohibited transactions that involve any *haram*, due to their Islamic environment.¹⁷⁸

Hence, the Islamic finance industry has emerged to achieve the desire of many Muslims and non-Muslims who wish to obtain such financing without interest. Non-Muslims can also take advantage of offers by Islamic banking, such as an Islamic lease or an Islamic stock option.¹⁷⁹

Islamic finance contracts were established in the life of the prophet Muhammed 1400 years ago.¹⁸⁰ During that period, Prophet Muhammad taught the people that interest (*riba*), gambling (*qimar\maisir*) and uncertainty (*gharar*) are forbidden. He taught the people that they should return everything that was kept with them on trust to the original owners.¹⁸¹

The modern experiment in Islamic finance was established in Egypt in 1963 and involved the creation of local savings banks. It was founded by Dr. Ahmed al-Najjar in the city of Mit Ghamer.¹⁸²

Before 1963, there were business transactions between people, but without an Islamic finance institution; for example, they did not practise usury because they believed that it was forbidden.¹⁸³

In 1973, the most important event in the history of Islamic finance took place, whereby a conference of finance ministers was held and they decided to establish the Islamic Development Bank, which opened in 1975 in Jeddah in Saudi Arabia.¹⁸⁴

¹⁷⁸ Ahamed Al-Suwaiddi, *The Finance of International Trade in the Gulf Arab States: A comparative between the conventional and Islamic Banking systems with Special Emphasis on The United Arab Emirates* (Unpublished PhD Thesis, University of Exeter Press 1991) 36.

¹⁷⁹ Frank Vogel & Samuel Hayes, *Islamic Law and Finance: Religion, Risk and Return* (Kluwer Law International 1998) 27.

¹⁸⁰ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions', *Company Lawyer* (2009) 30 (1) 1.

¹⁸¹ Ibid, p. 4.

¹⁸² Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 401.

¹⁸³ Zamir Iqbal, Abbas Mirakhor, Hossein Askari, *Globalization & Islamic Finance: Convergence, Prospects and Challenges* (Wiley Finance 2009) 13-14.

¹⁸⁴ Ahamed Al-Suwaiddi, *The Finance of International Trade in the Gulf Arab States: A comparison between the conventional and Islamic banking systems with special emphasis on the United Arab Emirates* (Unpublished PhD Thesis, University of Exeter Press 1991) 38.

In 1975, the Dubai Bank opened and became the first Islamic institution to provide Islamic financing contracts.¹⁸⁵ This was followed by many other Islamic banks, and now, even some conventional banks in America (such as Citibank) and in Europe (such as HSBC, Barclays and UBS Islamic) are playing a vital role in Islamic banking operations.¹⁸⁶

Although the Islamic finance is a fairly recent innovation (only four decades old), it has now reached the stage where it is meeting challenges and is in competition with other banking industries.¹⁸⁷

3.5 Distinguishing Features of Islamic Finance

There are four distinguishing features of Islamic finance. One of the most important ones is the adherence to numerous *Shariah*-related principles in its contracts,¹⁸⁸ which means that any financial returns must comply with *Shariah*.¹⁸⁹ In addition, Islamic financial products must involve real assets, and in *Shariah* this is known as legitimising.¹⁹⁰ However, the Islamic system respects other religions because socio-economic justice is central to the Islamic way of life.¹⁹¹

Secondly, there is no interest in Islamic financial contracts, only interest-free loans (*qard hasan*).¹⁹² Interest-bearing contracts are replaced by return-bearing contracts, which often take the form of partnerships, whereas the conventional interest-based banking system is fixed in advance. This is a fundamental difference between the Islamic and conventional banking systems.¹⁹³ Allah pronounces the following on interest in *Surat Al-Baqarah*:

“Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past,

¹⁸⁵ Ibid.

¹⁸⁶ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 54.

¹⁸⁷ Sudin Haron, ‘A Comparative Study of Islamic Banking Practices’, *J.KAU: Islamic Econ* (1998) 10 (1) 23.

¹⁸⁸ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) . 7.

¹⁸⁹ Ghassan Chammas, *The Islamic Finance Industry in Lebanon: Horizons, Enhancements and Projections* (Unpublished PhD Thesis, Ecole Supérieure Des Affaires 2006) 2.

¹⁹⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 23.

¹⁹¹ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* Brown Walker Press 2010) . 85.

¹⁹² Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 125.

¹⁹³ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 49.

and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein”.¹⁹⁴

The third feature is that Islamic finance is not purely commercial. It is multi-purpose and there are other considerations: religious, social, ethical and economic.¹⁹⁵ It provides a range of activities not offered by traditional banks, such as the interest-free loan or *Qard Hassan*. This is often used in a charitable context, such as the payment of school fees, wedding costs, medical treatment and the purchase of land to build a home.¹⁹⁶ For example, the bank lends someone £600 repayable within 6 months, but without interest. The Quran states in *Surat Al-Baqarah* about the *Qard Hassan*:

“Who is he that will lend God a loan, by expending his property in the way of God, that is good, by expending it for the sake of God, Mighty and Majestic, out of pureness of heart, and He will multiply (yudā‘if, also read yuda‘‘if) it for him manifold, up to ten or seven hundred times or more”.¹⁹⁷

The activity of the *Zakat* Fund: *Zakat* is the third of the five pillars of Islam. It means the giving of a specific share of one’s wealth to specific persons. The proceeds of *zakat* are only used for specific purposes under fixed headings – such as helping the poor. Allah mentions in the *Quran* persons who take the proceeds of *Zakat*.¹⁹⁸ The Quran states in *Surat At-Tawbah*:

“Zakat expenditures are only for the poor and for the needy and for those employed to collect [zakat] and for bringing hearts together [for Islam] and for freeing captives [or slaves] and for those in debt and for the cause of Allah and for the [stranded] traveler - an obligation [imposed] by Allah. And Allah is Knowing and Wise”¹⁹⁹.

Finally, Islamic finance is based on profit-and-loss sharing. This means that the lender bears the risk of a venture with the borrower because it is deemed that neither the lender nor the

¹⁹⁴ See verses 275 of Surah 2 of the Holy Quran.

¹⁹⁵ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010) . 85.

¹⁹⁶ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 57.

¹⁹⁷ See verses 244 of Surah 2 of the Holy Quran.

¹⁹⁸ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 29.

¹⁹⁹ See verses 60 of Surah 9 of the Holy Quran.

borrower is in control of the success or failure of the venture. This is one of the most important distinguishing features between Islamic banking and conventional banking.²⁰⁰

3.6 Islamic Finance Principles

One of the Islamic commercial rules is freedom to engage in business and financial transactions. This is because The Quran states in the Holy *Quran*: “Allah has permitted trade”²⁰¹ This means that everything is permissible unless it is stipulated by *Shariah* that it is forbidden. Islamic Jurisprudence in commercial transactions focuses on contracts, and specifically on what kind of contract is permissible or forbidden.²⁰² For example, The Quran states after the previous verse: “That is because they say trade is just like interest. But Allah has permitted trade and has forbidden interest”.²⁰³ Islamic finance contracts are based on *Shariah*.²⁰⁴ The basic framework for Islamic finance is a set of rules which seek to develop practices that are commensurate with the progress of banking and also in accordance with the provisions of *Shariah* and must stay within the limits of *Shariah* in all of their deeds and actions.²⁰⁵ There are several principles in the system of commercial transactions, but the most important are the prohibition of *riba*, *qimar* or *maisir*, and *gharar*. All of these prohibitions are based on the rules of legitimacy.²⁰⁶

3.6.1 Prohibition of Usury and Interest (Riba)

Riba was not something new in the Arabian Peninsula, even at the advent of Islam; the system of *riba* already prevailed there and the entire economy was based on usury. At that time, the Quraysh ruled Mecca and controlled the trade, especially between Yemen and Syria.²⁰⁷ This was lodged as a guarantee and material evidence of a proof of contract.²⁰⁸

The *Quran* and *Hadith* use the term *riba*, translated by Muslim jurists as interest or usury. So usury and interest are treated as synonyms for the Arabic word *riba*, but there are also some

²⁰⁰ Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 128.

²⁰¹ See verse 275 of Surah 2 of the Holy Quran.

²⁰² Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 2.

²⁰³ See verse 275 of Surah 2 of the Holy Quran.

²⁰⁴ Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 681.

²⁰⁵ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 100.

²⁰⁶ Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 2.

²⁰⁷ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 378.

²⁰⁸ Brian Kettell, *Islamic Finance in A Nutshell* (John Wiley & Sons Ltd 2010) 223.

other meanings, such as increase, growth, expansion and addition.²⁰⁹ *Riba* literally means “excess” and refers to any unjustifiable increase of capital whether through loans or sales.²¹⁰ There is also a definition of *riba* in jurisprudence: the increase over the original wealth without trading.²¹¹ For example, *riba* is a loan with a condition attached that the borrower will return the loan to the lender with interest.

3.6.1.1 Quranic verses that Mention the Prohibition of Usury (Riba):

The Islamic view on the prohibition of usury and other forms of *riba* as practices which unfairly consume others’ wealth is very clear. The *Quran* explicitly states in many different verses that *riba* is a serious sin:

First revelation: from *Surah al- Rum*:

“Whatever you give for usury, for increase through the property of people, will not increase with Allah. But what you give in zakah, desiring the countenance of Allah - those are the multipliers”.²¹²

Second revelation: in *Surah Al-Imran* a clear verse prohibiting *riba*:

“Oh you who believe, do not exact usury, doubled and multiplied, but fear Allah that you may be successful”.²¹³

Third revelation: from *Surah al-Baqara*:

“Those who take *riba* will not stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein”.²¹⁴

²⁰⁹ Emad H Khalil, ‘An overview of the Sharia’a prohibition of *riba*’ in Abdulkader Thomas (ed), *Interest in Islamic Economics: Understanding riba* (Routledge 2006).54.

²¹⁰ Hennie Greuning & Zamir Iqbal , *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 7.

²¹¹ Bahgat Al Sharif, *Law and Practice of Profit-Sharing in Islamic Banking with Particular Reference to Mudarabah and Murabahah* (University of Exeter Press 1990) 33.

²¹² See verse 39 of Surah 30 of the Holy Quran.

²¹³ See verse 130 of Surah 3 of the Holy Quran.

²¹⁴ See verse 275 of Surah 2 of the Holy Quran.

“Allah deprives *riba* of all blessing but blesses charity; He loves not the ungrateful sinner”.²¹⁵

“Oh believers, fear Allah, and give up what is still due to you from *riba* if you are true believers”.²¹⁶

“If you do not do so, then take notice of war from Allah and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to It”.²¹⁷

“And be fearful of the day when you shall be returned to Allah, then everybody shall be paid in full what he has earned and they shall not be wronged”.²¹⁸

3.6.1.2 A Hadith that Mentions the Concept of Usury (Riba):

Prophet Muhammad has prohibited *riba*, whether paying, taking, charging or even acting as a witness, and he ordered Muslims to avoid all amounts arising out of usury.²¹⁹ In the following, there are some Hadith of the holy Prophet Muhammad about the prohibition of *riba*. The relevant Hadith are:

From Jabir (Gbpwh): The Prophet (pbuh) cursed the receiver and the payer of interest, the one who records it and the witnesses to the transaction, and said: “They are all alike in guilt”.²²⁰

The Holy Prophet (pbuh) said: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt like for like, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand”.²²¹

It is reported that the Holy Prophet, on his last pilgrimage and in his last address, said, “Every form of interest (‘*riba*’) is cancelled; capital indeed is yours which you shall have. Wrong not, and you shall not be wronged.” God has given His injunctions that

²¹⁵ See verse 276 of Surah 2 of the Holy Quran.

²¹⁶ See verse 278 of Surah 2 of the Holy Quran.

²¹⁷ See verse 279 of Surah 2 of the Holy Quran.

²¹⁸ See verse 281 of Surah 2 of the Holy Quran.

²¹⁹ Yahia Abdul-Rahman, *The Art of Islamic Finance and Banking: Tools and Techniques for Community-Based Banking* (John Wiley & Sons, Inc 2010) 41.

²²⁰ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 4093* (Darussalaam Publishers 1999) 955.

²²¹ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 4063* (Darussalaam Publishers 1999) 953.

interest is totally forbidden. I first start with (the amount of) interest (which people owe) to ‘Abbas and declare it all cancelled.²²²

According to Abu Huraira the Prophet said, “Avoid the seven great destructive sins.” Then (the people) asked, “O Allah's Apostle, what are they?” He mentioned the worst seven things, and one of them was to eat up usury (*riba*).²²³

3.6.1.3 View of Islamic Scholars and Muslims about the Prohibition of Usury

More importantly, there is no difference of opinion among Muslims about the prohibition of *riba*. The traditional view is that it is forbidden. This is because the primary sources of *Shariah* (the *Quran* and *Sunnah*) strongly forbid it²²⁴. Though some scholars say that *riba* is usury, while the majority of them view *riba* as interest,²²⁵ all of them are agreed that *riba* is prohibited, either its payment or its receipt, and also either as usury or as interest.²²⁶

3.6.1.4 Prohibition of *Riba* in other Heavenly Religions

In addition to *riba* being forbidden in the Islamic religion, it is also prohibited in all revealed religions such as Christianity and Judaism. In other words, *riba* had been forbidden by the Jewish and Christian traditions before the Islamic religion. There have never been two views about its prohibition in any of these religions.²²⁷ It can clearly be said that *riba* is prohibited by three heavenly religions.²²⁸

3.6.1.5 Why has *Shariah* Prohibited *Riba*?

There are some reasons why the *Shariah* has prohibited usury. These include the fact that usury brings many economic and social disadvantages, such as exploitation, unemployment, the spread of transactions that are not real, and a lack of investment. However, the main reason for its prohibition is the achievement of justice; in the other words, to prevent injustice

²²² Sulaiman bin Shaggy Sajistani, *Sunan Abi Dawood : Hadith number: 3334 (Al-Rushd Publications 2003)* 371.

²²³ Muhammad al-Bukhari, *Sahih Bukhari Hadith number: 6857 (Darussalaam Publishers 1999)* 572.

²²⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 44; Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) (2009) 30 (1) 2.

²²⁵ Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 128.

²²⁶ Abdulkader Thomas, ‘An overview of the Sharia'a prohibition of *riba*’ in *Interest in Islamic Economics: Understanding *riba**. E. Khalil. Routledge, USA, 2006, p. 53.

²²⁷ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007). 53.

²²⁸ Petri Mantysaari, *The Law of Corporate Finance: General Principles and EU Law* (Springer Heidelberg Dordrecht 2010) 409.

caused by exploitation. *Riba* involves a transfer of wealth from the poor to the rich, turns people away from productive enterprise, encourages a tendency for wealth accumulation to be in fewer hands and leads to unjust enrichment, which means that people become selfish. It is necessary that those who have wealth should assist those without.²²⁹ Allah has warned of *riba*, and has also mentioned that usury is injustice, in *Surah Al-Baqara* from the holy *Quran*:

“you who have believed, fear Allah and give up what remains due to you of interest, if you should be believers and if you do not, then be informed of a war against you from Allah and his Messenger, but if you repent, and forgo it, you shall have your principal sums, the original amounts, not being unjust, by charging interest, and no injustice being done to you, by way of any diminution”.²³⁰

3.6.1.6 The Main Types of *Riba*

There are two kinds of usury (*riba*) in *Shariah*: *riba an-Nasia* and *riba al-Fadl*²³¹; these will be explained in detail below.

3.6.1.6.1 *Riba an-Nasia* (Excess of Delay)

Riba an-Nasia is also called *riba al-Qurudh* or *riba al-Quran*, but Islamic scholars and jurists prefer to use the term *riba al-Nasia*.²³² This kind of *riba* was practised in the pre-Islamic period in the Arabian Peninsula when it was known as *Riba al-Jahiliyya*. It was not forbidden at that time and was widespread during the time of prophet Muhammed. This kind of *riba* and the other type which will be discussed later are, however, both prohibited under *Shariah*, which strictly prohibits any loans or debts in which an increase accrues to the creditor, and also the charging of excess fees for late payments.²³³ *Riba an-Nasia* applies to loan transactions. It is a type of usury that arises due to an exchange not being immediate, with or without excess in one of the counter-values. It refers to an increase in the amount of a debt owing, due to a delay in payment of the debt or with the passage of time. *Riba an-Nasia* includes interest-based lending; compensation for lending; selling money for profit; or a predetermined payment for a loan, which may be a loan of money or a loan of goods, which

²²⁹ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009)38.

²³⁰ See verses 278-279 of Surah 2 of the Holy Quran.

²³¹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 2.

²³² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 50.

²³³ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing Co Ltd 2005) 73; Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 43.

in modern times is known as money lending.²³⁴ An example of *riba an-Nasia* is where a creditor lends money to a debtor for a fixed period of time at a determined rate of interest to be paid monthly; usually this interest occurs through interest-bearing loans in conventional financial transactions.²³⁵

In Islam, financial contracts which pay or receive interest are forbidden, so some banks use traditional Islamic products; for example, HSBC bank uses modes of Islamic finance such as *Musharakah* and *Murabaha* contracts.²³⁶

Essentially, in *Shariah*, for a contract to be valid it is necessary for it to be free from interest, gambling and uncertainty, as will be explained later.²³⁷ Therefore, any contract which includes one or more of these might be void under the principles of Islamic finance.

3.6.1.6.2 *Riba al-Fadl* (Excess of Surplus)

This type of usury occurs with the payment of an addition by the debtor to the creditor in exchange for commodities of the same kind, or the exchange of low quality for better quality commodities.²³⁸ The prophet Muhammed prohibited *riba al-Fadl* when he said: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish.”²³⁹ This statement by the prophet prohibited *riba al-Fadi*, especially for the commodities specified above, and also salt for salt.

Riba al-Fadl was prohibited because it could be used as a subterfuge for *riba-al-Nasia*, and the prohibition prevents circumvention of the *Shariah* as well as risk and uncertainty. Thus in

²³⁴ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing Co Ltd 2005) 73; Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 2.

²³⁵ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 2.

²³⁶ Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 681.

²³⁷ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 72.

²³⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 53; Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 3.

²³⁹ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 4063* (Darussalaam Publishers 1999) 953.

order to avoid this type of *riba*, the exchange of goods from both sides must be equal and instant.²⁴⁰

Overall, there is not a great distance between *riba an-Nasia* and *riba al-Fadl*; in fact they are almost identical except that *riba an-Nasia* relates to loan transactions and *riba al-Fadl* relates to exchange transactions. The *riba an-Nasia* type of usury was used before *riba al-Fadl*, especially in the pre-Islam age. The most important aspect to note is that all modern conventional banking transactions fall under the purview of *riba an-Nasia* because all loan transactions in conventional banks carry interest.²⁴¹

3.6.2 Prohibition of Gambling (Qimar/Maisir)

Gambling is the wagering of money or something which is gained by games of chance.²⁴² It refers to easily available wealth. The words *Qimar and Maisir* are used for this in Arabic terminology. Gambling is forbidden by the ethical framework governing Islamic finance.²⁴³ There is evidence from the Quranic verses which prohibits gains made from gambling.²⁴⁴ For example, in *Surah al-Baqara* Allah says:

“They ask you about wine and gambling. Say, in them is great sin and yet, some benefit for people. But their sin is greater than their benefit”.²⁴⁵

This prohibition of gambling means that a contract is void if it has an element of *qimar* or *maisir* because “it involves speculation and an attempt to amass wealth without putting [in] any productive effort”.²⁴⁶ In general, as mentioned, *Shariah* prohibits usury, uncertainty and gambling; therefore, gambling is forbidden in Islamic finance products and can affect the validity of the contract if it occurs. In Islam, commercial contracts have great importance and are mentioned in the *Quran* many times, using the word *Uqud*. The word *Uqud* is an Arabic word which literally means “obligation”. Islamic scholars have used *Uqud* in Islamic

²⁴⁰ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) . 51.

²⁴¹ Brian Kettell, *Frequently Asked Questions in Islamic Finance* (John Wiley & Sons Ltd 2010) 250; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 53.

²⁴² Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 4.

²⁴³ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 133.

²⁴⁴ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* Brown Walker Press 2010) 99.

²⁴⁵ See verse 219 of Surah 2 of the Holy Quran.

²⁴⁶ Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer*, (2009) 30 (1) 4.

contracts.²⁴⁷ In the first verse of the Surah Al-Maidah, Allah says: “O you who have believed, fulfill all contracts either between you and God and or between you and other people.”²⁴⁸ In *Shariah*, there are seven kinds of contracts,²⁴⁹ and these types will be discussed in terms of the forms and modes of Islamic finance.

3.6.3 Prohibition of Uncertainty (*Gharar*)

The third major prohibition is *gharar*. *Gharar* refers to uncertainty and risk-taking. It means “stake” or “chance”, and literally means “hazard”²⁵⁰. It is a type of sale in which uncertainty is included, such as the sale of birds or fish before they are caught.²⁵¹ Mustafa Al-Zarqa defined *gharar* as “the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling”.²⁵² There should not be any type of ambiguity that gives rise to speculation and if there are any kinds of uncertainty, ambiguity or non-disclosure about a subject matter in a contract, the contract is void.²⁵³

Gharar is forbidden in Islamic finance contracts.²⁵⁴ Games of chance are forbidden by the Holy *Quran* in Surah Al-Maidah, verses 90-91. In addition, the Prophet Muhammed prohibited sales through fraudulent means or *gharar* sales.²⁵⁵ Some of examples of uncertainty or *gharar* include:

1. Making a contract conditional on an unknown period or event.
2. Selling commodities or goods which the seller is unable to deliver.
3. Selling commodities on the basis of fraud or incorrect descriptions.
4. Transferring or assigning a debt without recourse to the seller.
5. Two sales in one contract where there is a sale and condition together.²⁵⁶

²⁴⁷ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 356.

²⁴⁸ See verse 1 of Surah 5 of the Holy Quran.

²⁴⁹ Angelo M Venardos, *Islamic Banking & Finance in South –East Asia: Its Development & Future* (World Scientific Publishing Co Pte 2005) 51.

²⁵⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 57-58.

²⁵¹ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 359.

²⁵² Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 58.

²⁵³ Hij Siti Faridah Abd Jabbar, ‘Islamic finance: fundamental principles and key financial institutions’, *Company Lawyer* (2009) 30 (1) 3.

²⁵⁴ Ibid.

²⁵⁵ Abdur Rahman Doi, *Shariah: The Islamic Law* (Ta Ha Publishers Ltd 1984) 359.

²⁵⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 60-61.

In order to avoid *gharar* in Islamic finance contracts, the contracts should be free from excessive uncertainty and the commodity must be defined, deliverable, clearly known to the contracting parties and determined.²⁵⁷

3.7 Forms and Modes of Islamic Financing Contracts

In Islam, there are various contracts (*Aqd*), such as financial contracts, exchange contracts, and contracts pertaining to work. What does *Aqd* mean in *Shariah*? Murshid al-Hayran defined an Islamic contract (*Aqd*) as “the conjunction of an offer emanating from one of the two contracting parties with the acceptance by the other in a manner that affects the subject matter of the contract”.²⁵⁸

A basic rule of *Shariah* is that all contracts are respected. Muslims must respect all contracts, whether between themselves or between Muslims and non-Muslims. Allah mentions this in many places in the Quranic verses, such as in *Surat Al-Maidah*, Allah says: “O you who have believed, fulfil [all] contracts”.²⁵⁹

In general, contracts are divided into oral and written ones. Oral contracts are those that are verbal, not written, while written contracts consist of an agreement presented on a handwritten document that has been signed by both the borrower and the lender.²⁶⁰

In Islam, the written contracts are legally binding and easier to enforce than oral contracts. The Quran states in *Surat Al-Baqarah* in the Holy *Quran* in verse 282: “O you who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice”.²⁶¹ Moreover, Prophet Muhammad wrote contracts and respected them.²⁶²

In *Shariah*, there are some essential elements or conditions in order to establish a valid contract agreement under *Shariah*, between either two or more persons. Some of these conditions are:

²⁵⁷ Ibid.

²⁵⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 103.

²⁵⁹ See verse 1 of Surah 5 of the Holy Quran.

²⁶⁰ Brian A. Blum, *Contracts* (Aspen Publishers 2007) 3.

²⁶¹ See verse 282 of Surah 2 of the Holy Quran.

²⁶² Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1783* (International Ideas Home Publishers 1998) 742.

1. Offer and acceptance in the contract: An offer is an expression of willingness to contract, while acceptance occurs after that. It is important to mention that the offer and acceptance must be made in the same meeting and not be conditional upon some other factor because a conditional contract is invalid in *Shariah*.
2. An offer and acceptance must be together in the contract agreement meeting and also be made in clear and decisive language.
3. The subject matter and fundamental components must be lawful.
4. The contracting parties must have the ability to execute the terms of the contract.²⁶³

Therefore, *Aqd* is a combination of an offer and acceptance and it is applied in every act, such as in an agency, mortgage, lease, remission of debt, or sale.

Indeed, the most crucial point of Islamic finance is *Aqd* (the contract). This is because everyone, whether a customer or a bank, needs to conclude a contract in all banking transactions, deposit facilities and financing facilities, where such contracts are introduced by Islamic banks. Examples, which will be discussed later, include *Mudaraba*, *Musharaka*, *Murabaha*, *Ijara*, *Bai bithaman ajil*, *Bai salam*, *Istisna*, *Qardh-al-hasan*, *Hawala* and *Tawarruq* contracts.²⁶⁴

Generally, in *Shariah*, there are two types of contracts, in relation to validity and legality: valid (*Sahih*) and invalid (*Fasid*). The validity of any contract in *Shariah* depends on the legality or illegality of its fundamental components (*Asl*) and subject matter; therefore, it is important to mention that all Islamic finance contracts must be in accordance with *Shariah* in order to be valid from a legal standpoint. For example, the majority of Islamic schools believe that usury (*Riba*) and uncertainty (*Gharar*) are causes of invalidity of a contract.²⁶⁵

Finally, the most important factor in Islamic contracts is that all contracts are valid, except what is forbidden in the *Quran* or *Sunnah*, or *Shariah* Board, such as the prohibition of usury, which is forbidden in the *Quran* and also in the *Sunnah*, so any contracts that include usury will be invalid for the reasons stated earlier.

²⁶³ Zaha Rina Zahari, *A Primer on Islamic Finance* (The Research Foundation of CFA Institute 2009) 16.

²⁶⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 105; Sudin Haron, 'A Comparative Study of Islamic Banking Practices', *J.KAU: Islamic Econ* (1998) 10 (1) 29.

²⁶⁵ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 118-120.

3.7.1 Islamic Financing Contracts

Islamic finance is a set of a unique form of financial contracts such as *murabaha*, *ijara*, *salam*, *istisnaa*, *mudaraba* and *musharaka*, which are compatible with the provisions of *Shariah* and its principles.²⁶⁶ The most important aims of Islamic finance are socio-economic justice and distributive justice, which are free from exploitation of any kind. These are important not only from the Islamic point of view, but in all religions.²⁶⁷

In general, Islamic finance contracts are based on the themes of community banking, socially responsible investing, and ethical finance, which define the levels of what is permissible or forbidden, so can clearly be said that there is a strong relationship between financial ethics and *Shariah* principles. What are financial ethics? Elmelki and Ben Arab define the term as: “the branch of Ethics that examines ethical rules and principles within the financial context”, and states that ‘financial ethics is a normative discipline, whereby particular ethical standards are formulated and then applied’.²⁶⁸

As mentioned before, *riba* (interest) is not allowed by Islamic banking, so it is important to offer an alternative. Islamic banking offers two types of financial contracts: contracts which deal with asset-based financing, such as *murabaha*, *salam*, *istisna* and *al-ijarah*, and business contracts which are based on partnership, such as *musharaka* and *mudarabah*.²⁶⁹

Following this introduction, the majority of Islamic finance contracts will be explained, the first of which is *Murabaha*.

3.7.1.1 *Murabaha* (Trade with Mark up or Cost Plus Sale)

The word *murabaha* in Arabic literally means profit and refers to the sale of a commodity at a price that includes a predetermined profit known by both parties. In *murabaha*, it is important that both parties agree to the sale of an asset, either a movable or immovable one, at the original cost plus profit. A *murabaha* contract is the most popular contract used in

²⁶⁶ Hij Siti Faridah Abd Jabbar, ‘The Shari’a Supervisory Board: a potential problem in Islamic finance’, *Company Lawyer* (2008) 29 (1) 29.

²⁶⁷ Ibid.

²⁶⁸ Anas Elmelki & Mounira Ben Arab, ‘Ethical Investment and the Social Responsibilities of the Islamic Banks’, *International Business Research* (2009) 2 (2) 124.

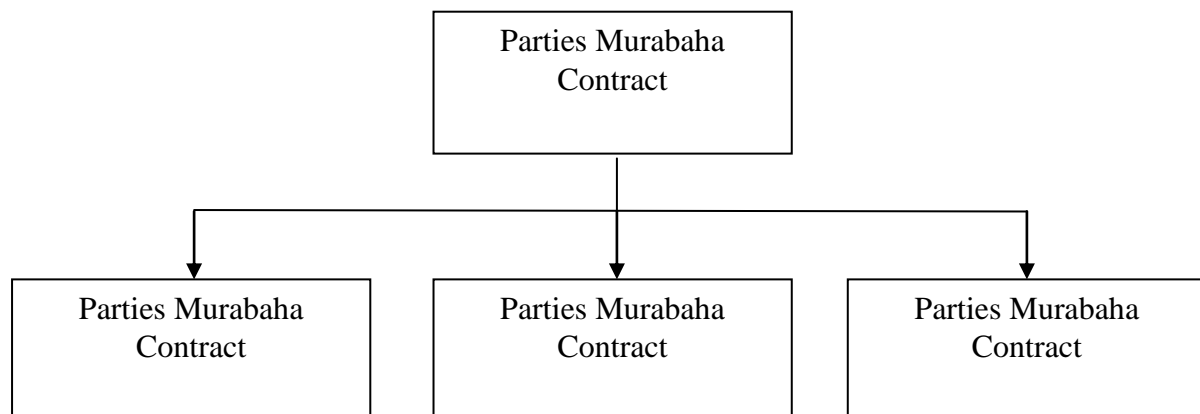
²⁶⁹ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 181.

Islamic financing, about 59% of all the value of Islamic banking products.²⁷⁰ This is because *murabaha* is less risky than other financial contracts, such as *musharaka* and *mudaraba*, and the period of time for payment is agreed in advance between the seller and the buyer. *Murabaha* is based on the principle of incremental cost or cost plus profit of sale.²⁷¹ For example, a bank purchases commodities and after that the bank resells them to a buyer at a cost plus profit, as agreed between both parties. In other words, if the cost price of a commodity equals £800 and the profit margin equals £300, the *murabaha* price equals £1100. Therefore, it is possible to say that *murabaha* is divided into two main types: cash *murabaha* and credit *murabaha*.²⁷²

Regarding the parties involved, there are three parties in *murabaha* contracts: the seller or receiving party (the Islamic bank) who buys a commodity; the buyer or ordering party (the customer of the Islamic bank) who wishes to buy commodities from the seller; and the provider or facilitator, between the seller and the buyer.²⁷³

This model is called *murabaha* to the purchase order. After Figure 3.1, the steps in the *murabaha* will be explained.

Figure 3.1: Overview of the parties in a *Murabaha*



The steps in the process of *murabaha* sale are as follows:

²⁷⁰ Kun-Ho Lee & Shakir Ullah, 'Integration of Islamic and Conventional Finance', *International Review of Business Research Papers* (2007) 3 (5) 245.

²⁷¹ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2 009) 30(1)5; Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 129.

²⁷² Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 87-88.

²⁷³ Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 682.

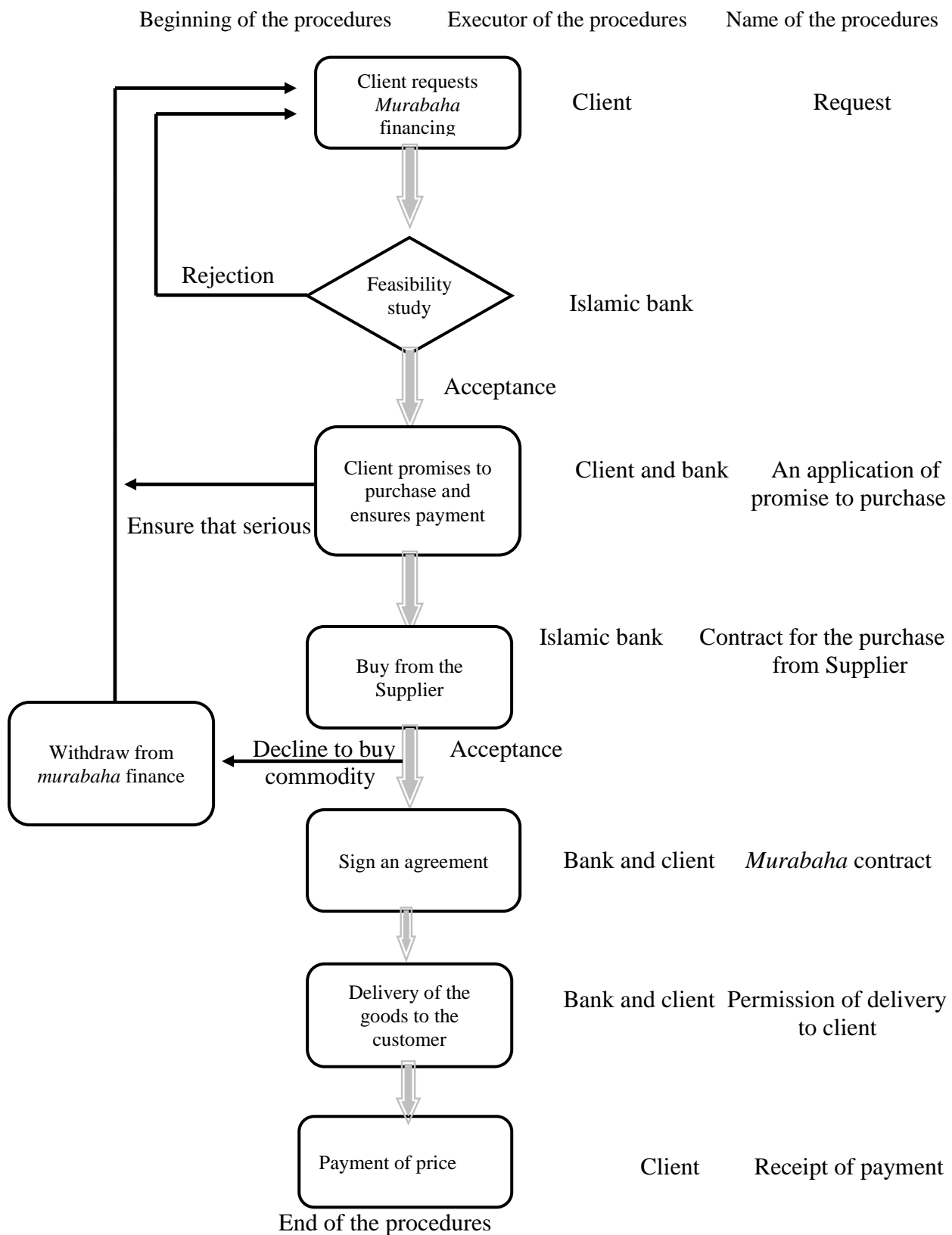
The client applies to the Islamic bank requesting *murabaha* finance, and this request must include a certain commodity with a specified price and details. An agreement between two parties is signed by the Islamic bank and the client, who enter into a *murabaha* contract. This agreement is not, however, considered the main financing agreement. The client promises the bank they will purchase a commodity which they have requested when applying. This type of non-binding promise may cause risks in *murabaha* financing, and these will be discussed later. After that, the Islamic bank studies the feasibility of the client's request and carries out a risk assessment as well. In the case of approval, the bank buys the item required from the supplier. After the commodity is purchased and possessed by the Islamic bank, it sells it to the client as a deferred sale on an agreed-upon price and the client has the right to accept the offer or decline it. If the client accepts it, both parties sign the final *murabaha* contract. The delivery of the commodity to the customer takes place, either from the bank or the supplier. It is important that the goods are free from defects and delivered within the agreed time. The payment of the *murabaha* price is made by the client on the agreed date, either in one transaction or by instalments.²⁷⁴

To highlight the above, an example of *murabaha* finance follows. If the client (A) wishes to buy a car from the Islamic bank (B), first of all, A and B sign an agreement to enter into a *murabaha* sale and this agreement is a primary contract and non-binding. Then A should apply to B requesting a car and it is important for A to give B all the specifications and details for the car, and B gives a serious promise to purchase the car for which A has given the details. After that, if the car is available from B, this means that A and B do not need to use a third party supplier (C), otherwise B buys it from C. After the car is bought and possessed by B, a final contract between A and B is signed for the agreed price plus a mark-up, and the payment method is either made in one transaction or in instalments. Finally, A receives the car from B. It might be the case that A agrees with C directly and B is only an intermediary between them. This method of sale is called *murabaha* finance.²⁷⁵ This type of contract is the one most commonly applied in Islamic banks, although there are several types of Islamic financing contracts, because *murabaha* entails less risk than the others.

²⁷⁴ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 176-188.

²⁷⁵ *Ibid*, pp. 5-6.

Figure 3.2: Procedures of the *murabaha* contract



Source: Murabaha Financing as Carried out by Islamic Banks between Theory and Practice (2003)

Generally, the *murabaha* contract is permitted by *Shariah*, because it is a kind of a sale and the sale is permitted by the *Quranic* verses. Allah mentions in *Surah Al-Baqara*: “Allah has permitted trade and has forbidden interest”.²⁷⁶ In Islamic jurisprudence, the sale is an exchange of one thing with another thing and both are valued. Therefore, a *murabaha* contract is permitted by *Shariah*, but its steps must adhere to the *Shariah* sources, either the primary sources of the *Quran* and *Sunnah*, or the secondary sources of *Ijma* and *Qiyas*.

There are specific conditions for a *murabaha* contract, as follows:

1. The conventional condition is that all activities of *murabaha* must be compliant with *Shariah*.
2. The goods must be described and defined and should be real, though not necessarily tangible.
3. The price of the goods and the amount of the seller's mark-up must be known and agreed to by both parties at the time of contracting.
4. The Islamic bank (seller) is responsible for any damage to the goods before delivery to the buyer.
5. The Islamic bank (seller) must own and possess the goods before reselling them to the buyer.
6. The Islamic bank should add a profit before selling the commodity to the client, in order for the contract to be on a cost plus mark-up basis.
7. The seller must explain all the flaws in the commodities and all aspects relating to the commodities, any defects or additional benefits, and the mode of payment to the original seller/provider.
8. The profit should be added by the seller before selling the commodity to the client, in order for the contract to become a *murabaha* one. This involves the original price and profit, which was added for the risk and the duration of the repayment.²⁷⁷

Finally, *murabaha* has been applied in Islamic banks since 1970 and is known as *murabaha* to the purchase orderer. It is the most commonly practised model in Islamic banks, and is permitted by all Sunni schools. As mentioned earlier, the *murabaha* contract must be between two parties or more and it is important to agree on the price and payment method. There are

²⁷⁶ See verse 275 of Surah 2 of the Holy Quran.

²⁷⁷ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 27; Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 5-7; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 217-218.

three options for paying the *murabaha* price: all at once, in instalments, and partly at once and partly in instalments. A *murabaha* contract is not a loan, it is a type of sale, and usually, the price of *murabaha* is a deferred payment.

There is an issue about compensation. If an Islamic bank buys a commodity for a client after the client has promised to buy it, and then the client refuses to buy it, the Islamic bank can sell the commodity to someone else and the client pays the difference in price which was lost by the bank. Through *murabaha*, Islamic banks may become involved in the trading of goods, which is a prohibited field for conventional banks.²⁷⁸

3.7.1.2 *Musharaka* (Partnership or Joint Venture)

The literal meaning of the word *musharaka* is ‘sharing’, and it refers to Islamic financing contracts which are used by Islamic banks.²⁷⁹ *Musharaka* is a contract whereby the Islamic bank and a client agree to combine their financial resources for the establishment or running of a business or project, or for undertaking any kind of business activities.²⁸⁰ A *musharaka* contract involves a partnership between two parties or more, and it is based on capital at work.²⁸¹ *Musharaka* and *mudarabah* are very similar in terms of a profit sharing agreement, so any profit or loss from the project is shared between the partnership parties.²⁸² A *musharaka* contract is not as popular as other Islamic financing contracts,²⁸³ but it is considered one of the most authentic models in *Shariah* and there are many theoretical forms of Islamic banking based on a *musharaka* contract.²⁸⁴ Such a contract is permitted by both the *Quran* and *Sunnah* and its principles are derived from *Shariah*. The *Quran* states in the holy *Quran*: “A lot of partners in business oppress one another, except those who believe and do righteous good deeds, and they are few”.²⁸⁵ Evidence of the legality of *musharaka* from the

²⁷⁸ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 7.

²⁷⁹ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 1.

²⁸⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 307; Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 683.

²⁸¹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 4; Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 178.

²⁸² Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: Interest-free or interest-based’, *Science Direct* (2009) 17 (1) 129.

²⁸³ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010) 187.

²⁸⁴ *Ibid.*

²⁸⁵ See verse 24 of Surah 38 of the Holy Quran.

Sunnah is: In *Hadith Qudsi*, it was narrated by *Abu Huraira* that the Prophet Muhammad reported that Allah says:

“I am the third between two partners, as long as they do not betray each other; where one of the two betrays the other, I turn against (leave) them’. And Prophet Muhammad said: ‘The Hand blessing of Allah is on two partners’ parties as long as they do not betray each other’.”²⁸⁶

There are two basic categories of *musharaka* which can be summarised in the following points:²⁸⁷

1. *Sharika mulk* (property partnership): This means a partnership based on joint ownership between two persons or more of a particular property.²⁸⁸
2. *Sharika aqd* (contractual partnership): This means a partnership based on a contractual relationship and profits to be shared, such as *a joint commercial enterprise*.²⁸⁹ This kind of *musharaka* involves five subdivisions:
 - i. *Sharika al Mufawadah* (full authority and obligation or universal partnership): This kind of contract refers to sharing everything on an equal basis. It is a limited partnership in equal capital contributions, responsibility, and full authority on behalf of others.²⁹⁰
 - ii. *Sharikat al-Inan* (restricted authority and obligation): This means a limited partnership with unequal capital contributions. There is not a share of equal responsibility between the partners of *Sharikat al-Inan*.²⁹¹ It is considered the most used type of *musharaka* in Islamic banking.²⁹²
 - iii. *Sharikah al-wujuh* (partnership in creditworthiness): A partnership based on the creditworthiness of one or both parties in which the ratio of profit and loss

²⁸⁶ Sulaiman bin Shaggy Sajistani, *Sunan Abi Dawood : Hadith number: 3383* (Al-Rushd Publications 2003) 375.

²⁸⁷ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 110.

²⁸⁸ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 183.

²⁸⁹ Ibid.

²⁹⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 310.

²⁹¹ Ibid.

²⁹² Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer*, (2009) 30 (1) 4.

is based on the liability borne;²⁹³ for example, joint credit purchase of particular goods and sale at a profit.²⁹⁴

- iv. *Sharikat al-Abdan* (also known as *Sharikat al-Taqaful* and *Sharikat al-mal*) (partnership in labour or crafts): It means that two persons become partners in one company and this company is based on the contribution of human efforts and capital;²⁹⁵ for example, the partnerships between teachers, medical practitioners and transport owners.²⁹⁶
- v. *Sharikat al-mudaraba* (labour partnership): This means an agreement between two parties to do business, whereby one of them provides capital and another party labour with the objective of making a profit, and it is based on a partner's experience or his skills.²⁹⁷ This type of *musharaka* contract is mentioned in the Holy *Quran* in *Surat Al-Muzzammil*: "others travelling through the land, seeking of Allah's Bounty".²⁹⁸

There are some basic rules of *musharaka*, which should be fulfilled by both parties. They include the following:

Capability of partners: They must be able to enter into a contract, and also be sane and mature. Overall, in a *musharaka* contract, the liability for both partners is normally unlimited.²⁹⁹ The contract must take place with the free consent of the parties and without deception, duress or misrepresentation.³⁰⁰

Distribution of profit: The main principles of *musharaka* are profit and loss, and these are shared between both parties. In a *musharaka* contract, it is important to determine the ratio of profit for each partner.³⁰¹ Most of the Muslim jurists believe that profits should be distributed among the partners in business on the basis of proportions settled by them in advance. Thus

²⁹³ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 4.

²⁹⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 311.

²⁹⁵ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 110.

²⁹⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 310.

²⁹⁷ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 4.

²⁹⁸ See verse 20 of Surah 73 of the Holy Quran.

²⁹⁹ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 13.

³⁰⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 312.

³⁰¹ Ibid.

in terms of determining the percentage of profits between the partners, it is necessary for them to be determined in advance.³⁰²

Rules relating to *musharaka* capital: According to the majority of Muslim jurists, the capital invested by each partner must be in the form of liquid assets.³⁰³ In this respect, it is important to mention that the contract of *musharaka* is based only on money. This means that goods or commodities are not allowed in a *musharaka* contract. However, *Imam Malik*, who is the owner of the second school of *Sunna*, holds a different view. He said: ‘The liquidity of capital is not a condition for the validity of the *musharaka* contract. That means that commodities are permissible in *musharaka*’.³⁰⁴

Mutual relationships among partners and *musharaka* management rules: According to the management of business, in a *musharaka* contract every partner enjoys equal rights in all respects and both partners have a right to participate and work; that means that both partners may be involved in the management of the business. However, in other contracts, such as *mudaraba*, the owner of capital cannot participate, and in Islamic jurisprudence this is known as *rabb-ul-mal*.³⁰⁵ The partners may appoint a managing partner by mutual consent and they might agree in advance that one party is a sleeping partner.³⁰⁶

Treatment of profit and loss: In *Shariah*, it is an essential aspect in a partnership that profit and loss are shared between both partners. According to two Islamic schools (*Hannifi* and *Hanbali*), the ratio of distribution of profit must be agreed upon at the time, otherwise the contract will be not valid in *Shariah*. Regarding profit and loss, there are some rules relating to them, one of which is that the basis or ratio should be decided at the beginning of the partnership as a sharing profit and allocated in percentages. In the case of loss, both partners will have to share the loss in proportion.³⁰⁷

Finally, *musharaka* involves a mutual contract between two or more parties to participate in commercial activities. *Musharaka* is similar to a *mudarabah* contract, although there are differences between them, which will be discussed after explaining the *mudarabah* one. Profits and losses are shared between both partners, and either or both can undertake the

³⁰² Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 7.

³⁰³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 313.

³⁰⁴ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 8.

³⁰⁵ *Ibid*, p. 13.

³⁰⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 316.

³⁰⁷ *Ibid*.

management of the project. *Musharaka* involves a venture of limited duration. If any one of the partners wishes to terminate the *musharaka*, while the other partner or partners wish to continue with the business, this purpose can be achieved by mutual agreement. There are two basic categories of *musharaka*: *Sharika mulk* and *Sharika aqd*.

3.7.1.3 *Mudarabah* (Profit and Loss Sharing)

Mudarabah is a special type of partnership and a kind of Islamic financing contract. A *mudarabah* contract is trust-financing, equity-sharing, trustee profit-sharing and a sleeping partnership.³⁰⁸ It is based on the principles of profit-loss-sharing. It is an agreement between two partners, or more than two: the Islamic bank or a capital provider and an entrepreneur, whereby the provider gives money to another for investing in a commercial enterprise. The investment comes from the provider, called in Islamic *Fiqh* books *rabb-ul-mal*, while the management and work is the exclusive responsibility of the other, who is called the *mudarib*. The *mudarib* contributes his labour and expertise, while the provider or investor contributes his money to investing it in commercial activities that are consistent with the principles of *Shariah*.³⁰⁹ A *mudarabah* contract, like other Islamic financing contracts, is a lawful item of trade, so it comes under *Shariah* and *Shariah* principles. Therefore there are some cases that can make the *mudarabah* contract void, such as trade in swine or wine.³¹⁰

The *Quran*, *Sunnah* and the consensus permit a *mudarabah* contract. According to the *Quran*, Allah has permitted *mudarabah* in many verses of the Holy *Quran*, as for example in this verse in *Surat Al-Muzzammil*: “others travel through the land, seeking of Allah's Bounty or seeking grace of Allah”.³¹¹ It is clear from this Quranic verse that such a contract is permitted.³¹² Regarding the permission of *mudarabah* from the *Sunnah* side, there are a number of sayings of the holy Prophet Muhammed about *mudarabah* as follows:

Mudarabah contracts offered by the Prophet's uncle were approved by the Prophet.³¹³

Abu Musa wanted to remit public money to the *Bayt al Mal*. He gave the amount to

³⁰⁸ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 1.

³⁰⁹ David J. Jonsson, *Islamic Economics and the Final Jihad: The Muslim Brotherhood to the Leftist/Marxist - Islamist Alliance* (Xulon Press 2006) 146; Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 120.

³¹⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 322.

³¹¹ See verse 20 of Surah 73 of the Holy Quran.

³¹² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 321.

³¹³ Ibid.

Abdullah bin Umar and his brother, who traded with it. The Caliph's assembly treated it as an ex post facto *Mudarabah* and took half of the profits earned by the two brothers, because the public money in their hands was not the loan.³¹⁴ Caliph Umar also used to invest orphans' property on the basis of *mudarabah*.³¹⁵

There is no difference of view among Islamic jurists about the legitimacy of *mudarabah*, because people might need for this contract either providers of the capital or entrepreneurs. It is desirable for the provider to find a person who has good experience to manage the project and for an entrepreneur who uses his skills and expertise to invest the capital as agreed.³¹⁶ According to some studies, there are those who say that there is no difference between a *mudarabah* contract and conventional banking, and this similarity lies in the cost of capital.³¹⁷ The importance of this section is that the similarity between *mudarabah* and *musharaka* involves partnership arrangements, but there are differences between them that can be summarised in the following points:

1. In *musharakha* all partners invest, while in *mudarabah* the investment comes from *rabb-ul-mal*.³¹⁸
2. In a *musharaka* contract, the partnership is in the profit and also the capital, while the partnership in *mudarabah* is in the profit but not in the capital.³¹⁹
3. In *musharaka*, all parties can participate or intervene in the management of the business and work for it, while in *mudarabah* the provider (*rabb-ul-maal*) does not participate or intervene in the management of the business or in the daily operations of the project.³²⁰
4. In *musharaka*, the profit and loss are shared between the financier and the entrepreneur according to the agreed ratio, while in *mudarabah* the owner of the capital only suffers the loss and the entrepreneur loses his provision of labour or his already expended labour.³²¹

³¹⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 321.

³¹⁵ Ibid.

³¹⁶ Ibid.

³¹⁷ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 127; Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 2.

³¹⁸ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 54.

³¹⁹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 308.

³²⁰ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 13.

³²¹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 308; Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 2

5. In *musharaka*, the liability of the partners is unlimited, while in *mudarabah* the liability of the provider (*rabb-ul-mal*) is limited to his investment, unless he has permitted the entrepreneur to incur debts on his behalf.³²²
6. In *musharaka*, the capital is a joint pool between all the partners, while in *mudarabah* the entrepreneur (*mudarib*) can earn his share in the profit only, not in the capital, because the financier owns the capital.³²³

Overall, *mudarabah* is an investment partnership between two or more parties. The first partner is called the financier and the second partner is called the entrepreneur, whereby the financier provides capital to the entrepreneur to invest it in a business activity. The *mudarabah* contract is based on *Shariah* principles, but is not limited to Islamic banking. It is necessary for the legality of a *mudarabah* contract that all parties agree on a definite proportion of the actual profit at the beginning of the contract. The profit might be equally shared between the parties and they can allocate different proportions between them as agreed. The original price and the profit should be made known to the second buyer and the first buyer must own and possess the goods before he sells them to the second buyer.³²⁴

3.7.1.4 Ijara (Leasing Contract)

Ijarah is a contract under *Shariah* principles, so it is permitted by Islamic jurists. It is an agreement between two parties: the first one is a financial institution or lessor and the second is the lessee.³²⁵ In Arabic terms, the lessor is called *mujir*, the lessee is called *mustajir* and the rent is called *Ijarah*.³²⁶ The *Ijarah* contract is very similar to an operating leasing contract.³²⁷ The *Ijarah* contract is one of the Islamic financing contracts, which are applied in Islamic banks, whereby the Islamic bank buys the asset from the seller, after which the Islamic bank rents it to the buyer at an agreed price plus profit for a certain period at a fixed rental charge.³²⁸ The figure below shows how *Ijarah* works, presenting the steps of *Ijarah* between the bank and supplier and the end of the proceeding notes the lessee (*mustajir*).

³²² Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 13.

³²³ Ibid.

³²⁴ Graeme Newell & Karen Sieracki, *Global Trends in Real Estate Finance* (John Wiley & Sons Ltd 2010) 175.

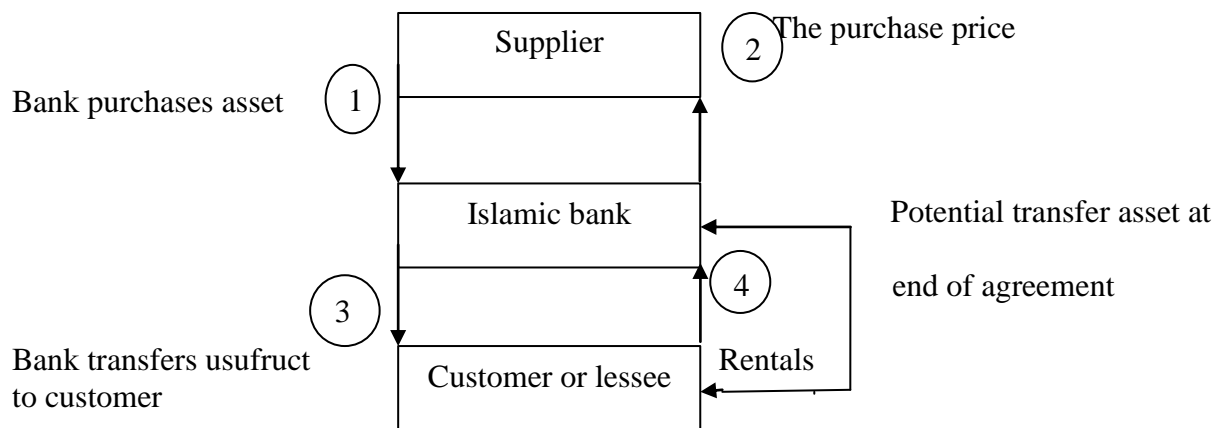
³²⁵ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 55.

³²⁶ Ibid, 54.

³²⁷ Fahim Khan and Mario Porzio, *Islamic Banking and Finance in the European Union: A Challenge Studies in Islamic Finance, Accounting and Governance* (Edward Elgar 2010) 97.

³²⁸ Graeme Newell & Karen Sieracki, *Global Trends in Real Estate Finance* (John Wiley & Sons Ltd 2010) 174-175; Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 129.

Figure 3.3: How does *Ijarah* work



Source: Islamic Financial Services (2005)

The term *Ijarah* in Islamic jurisprudence (*fiqh*) is used for two different situations and can be summarised in the following points:

The first kind of *Ijarah* relates to services provided by people. *Ijarah* means to employ the services of a person: a salary is paid to him for his hired services and for agreed considerations between the lessor (*mujir*) and the lessee (*mustajir*).³²⁹ There are many Quranic verses about this type. For example, Allah mentions the *Ijarah*, when he explains the story between the Prophet Moses and Prophet Shuaib in the Holy *Quran* in *Surat Al-Qasas*:

“Then one of the two women came to him walking with shyness. She said, "Indeed, my father invites you that he may reward you for having watered for us". After that, she said: "O my father, hire him. Indeed, the best one you can hire is the strong and the trustworthy". Then, the Prophet Shuaib asked Prophet Moses: He said, "Indeed, I wish to wed you one of these, my two daughters, on [the condition] that you serve me for eight years”.³³⁰

The *ijarah* from Sunnah states that the Prophet Muhammed said: Pay to the worker or the lessee (*mustajir*) his wages before his sweat has dried. In addition, The Prophet also said that there are three people who will find him on the Day of Judgement as their enemy. One of

³²⁹ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 55.

³³⁰ See verses 26-27 of Surah 28 of the Holy Quran.

these three is: “The man who employs a worker on wages, then takes the full measure of work from him, but does not pay him his wages”.³³¹

The second type of *Ijarah* contract is related to assets. In this case, *Ijarah* means selling the benefit to transfer the usufruct of a particular property to another person in exchange for a fixed price or wage from the lessee (*mustajir*).³³² In this kind of *Ijarah*, it is important to be clear that the rules of *Ijarah* are similar to the rules of sales, because both contracts involve transfer of some assets or properties to another.³³³

In order for an *Ijarah* contract to be valid, a number of general conditions must be present:

1. The contract of *Ijarah* must be capable of being fulfilled and performed.³³⁴
2. The usufruct of the goods should have value.³³⁵
3. The contracted goods must be lawful according to *Shariah*. Otherwise, it will be unlawful or *Haram*.³³⁶
4. The lessor must be able to deliver the contracted goods on the agreed date and have full possession.³³⁷
5. The lessor should hand the contracted goods to the lessee as per the agreed conditions.³³⁸
6. The lessee (*mustajir*) should be capable of undertaking the job and be physically fit as well.³³⁹
7. The rent must be specifically fixed for the contracted goods.
8. The subject of *Ijarah* should be specifically known and identified to the lessee (*mustajir*).³⁴⁰

³³¹ Muhammad al-Bukhari, *Sahih Bukhari Hadith number: 2270 International Ideas for Publishing & Distribution 1998*) 423.

³³² Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 7.

³³³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 380.

³³⁴ Ibid.

³³⁵ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1).

³³⁶ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 55.

³³⁷ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 7.

³³⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 380.

³³⁹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1). 7.

³⁴⁰ Ibid.

After these conditions, it is possible to say that the basic elements of *Ijarah* are the parties (lessor and the lessee), subject matter, rent and period of time.

There are those who say that *Ijarah* is similar to conventional leasing while others say there are some differences. All opinions will be discussed later in the assignment.³⁴¹

3.7.1.5 Bai Bithaman ajil (Deferred Payment Sale, Credit Sale)

Bai bithaman ajil is a contract between two parties. It is a type of Islamic financing contract and closely related to the *murabaha* one. *Bai bithaman ajil* refers to the sale of goods and purchase transaction on a deferred payment basis in a pre-agreed payment period, whereby the delivery of goods is immediate and the payment is deferred.³⁴² More precisely, many people cannot afford to purchase a house on a cash basis; therefore, they will buy the house from an Islamic bank and the payment is deferred on credit, and is usually payable by monthly instalments.³⁴³ This contract is used for real property, vehicles, houses and the financing of other client goods.³⁴⁴ Technically, this contract is based on the activities of selling and buying.³⁴⁵

From a legal aspect, *bai bithaman ajil* is permitted by *Shariah* because it is a sale, not a loan, and the *Quran* permits the sale. The *Quran* states in the Holy *Quran* in *Surah Al-Baqara*: “Allah has permitted trade and has forbidden interest”.³⁴⁶ Hence, in Islamic principles, profit from sale is lawful, while profit from loans, such as usury (*riba*) is unlawful. In this regard, Islamic jurists allow profit in *bai bithaman ajil* due to deferred payment.³⁴⁷ Overall, *bai bithaman ajil* works according to the principles of *Shariah* and its practical application.³⁴⁸ This contract is known in Islamic jurisprudence as (*Fiqh*) *bai bithaman ajil*, while in conventional financing it is called a contract of loan between the bank and the client.³⁴⁹

³⁴¹ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 55.

³⁴² Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 7.

³⁴³ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 87.

³⁴⁴ Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: interest-free or interest-based’, *Science Direct* (2009) 17 (1) 129.

³⁴⁵ Mohd Nasir bin Mohd Yatim, ‘A review on conflicting issues in a deferred payment sale product of a Shari’Ah-compliant banking business’, *International Journal of Economics and Finance* (2009) 1 (2) 256.

³⁴⁶ See verse 275 of *Surah 2* of the Holy *Quran*.

³⁴⁷ Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 682.

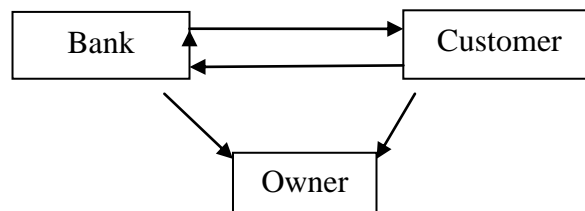
³⁴⁸ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 88.

³⁴⁹ *Ibid*.

Theoretically, there are similarities between *bai bithaman ajil* (deferred payment sale, credit sale) and conventional financing. Two financial systems will be discussed in Chapter four to clarify the similarities and differences between the two systems.

Bai bithaman ajil essentially involves three separate agreements. The first agreement details the asset to be acquired and these details are identified by the customer. The second agreement applies to when the Islamic bank sells the asset to the customer (buyer). The third applies to when the Islamic bank can sell the property in the event of failure to pay by the customer.³⁵⁰ The figure below depicts the structure of *bai bithaman ajil* financing.

Figure 3.4: The Structure of *Bai' Bithaman Ajil* (BBA) Financing



Source: Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning (2005)

What are the mechanics of *bai bithaman ajil* financing?

1. Client identifies the asset that is to be acquired.
2. Islamic bank determines the financing period and nature of repayment;.
3. Islamic bank purchases the assets from the owner on cash basis.
4. Islamic bank subsequently sells the asset/property to the customer at the original price plus the profit margin for a specific period.
5. Client repays the bank by instalments within the financing period.³⁵¹

BBA is very similar to *murabaha*. However, there are some differences between them; for example, in BBA the customer pays for the asset/property on the basis of instalments and the Islamic bank does not need to disclose its profit margin to the customer, while in *murabaha* it

³⁵⁰ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing Co Ltd 2005) 78.

³⁵¹ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 7; Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 90.

is different as the payment might be made all at once or in instalments and the customer is informed of the Islamic bank's profit margin.³⁵²

3.7.1.6 *Bai Salam* (Forward Selling)

Bai salam is a contract that is based on a forward sale concept.³⁵³ Literally, it refers to the future. Technically, a *bai salam* contract refers to an agreement between the Islamic bank (seller) and the customer (buyer) whereby the Islamic bank undertakes to supply specific goods to the buyer at a future date in exchange for an advanced price fully paid at the time of the contract.³⁵⁴ In this contract, the price is paid in advance and the supply of goods is deferred, while in other contracts such as *istisna* and *murabaha* it may be paid in cash or by instalments.³⁵⁵ The objects of this contract are commodities or goods and cannot be gold, silver or currencies. *Bai salam* is offered by Islamic banking and is one of the important contracts applied in Islamic banks, because it is mostly used for the trading of farming activities.³⁵⁶ In other words, it is applied to agricultural products and to fungible manufactured goods.³⁵⁷ Therefore, it is used for primary contracts of exchange in Islamic commercial law. Legitimately, it is permitted by both the *Quran* and *Sunnah*. In the *Quran*, Allah says:

“O you who believe, when you deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing”.³⁵⁸

In the Hadith both Muslims and Bukhari report that Ibn Abbas says that when the Prophet Muhammed came to Madinah,³⁵⁹ they were paying one or two years in advance for fruits and the prophet says:

³⁵² Ibid.

³⁵³ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: interest-free or interest-based', *Science Direct* (2009) 17 (1) 129.

³⁵⁴ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 9.

³⁵⁵ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 139.

³⁵⁶ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* Brown Walker Press 2010) . 305.

³⁵⁷ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 61.

³⁵⁸ See verse 282 of Surah 2 of the Holy Quran.

³⁵⁹ Al-Madinah l-Munawwarah is a city in the Hejaz region of western Saudi Arabia, and serves as the capital of the Al Madinah Province. It is the second holiest city in Islam, and the burial place of the Islamic Prophet Muhammad. It is historically significant, as it was his home after the *Hijrah*.

“Those who pay in advance for anything must do so for a specified measure and weight and for a specified time”.³⁶⁰

There are some mandatory conditions of *bai salam*, which can be summarised in the following points.

1. In *bai salam*, it is necessary for the validity of the contract that the buyer pays the price in full in advance to the seller at the time of effecting the contract; otherwise the contract will be void.³⁶¹
2. The object of exchange must be fungible, of quality and clearly defined physically and quantitatively as to the size, volume and colour.³⁶²
3. *Bai salam* only deals with goods as long as the goods are fungible. Gold and silver are not allowed in this contract, because these are regarded as monetary value exchanges, while the aim of *bai salam* is to meet the needs of farmers – who require money in order to grow their crops – and of traders for import and export businesses.³⁶³
4. In terms of the delivery of the goods the exact date and place of delivery must be specified in the contract, because the time of delivery is an essential part of this contract.³⁶⁴
5. It must be ensured that the goods are able to be delivered when they are due.³⁶⁵
6. The customer (buyer) cannot enjoy ownership rights over the purchased commodities before taking possession of them.³⁶⁶
7. The goods of the *bai salam* contract should remain in the market from the day of the contract up to the date of delivery.³⁶⁷

³⁶⁰ Muhammad al-Bukhari, *Sahih Bukhari Hadith number: 2239 International Ideas for Publishing & Distribution 1998*) 417; Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1604 (International Ideas Home Publishers 1998)* 655.

³⁶¹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 9.

³⁶² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 255.

³⁶³ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 9.

³⁶⁴ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 139.

³⁶⁵ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 255.

³⁶⁶ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 9.

³⁶⁷ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 62; Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 9.

3.7.1.7 Istisna (Order to Manufacture)

Istisna is a contract of sale where the seller is the manufacturer and the customer is the purchaser of future manufactured goods.³⁶⁸ This kind of contract is offered by Islamic financial institutions. The *istisna* contract was not created by the Islamic banks, but it refers to a contract adopted and redrafted by such banks to comply with the provisions of *Shariah*.³⁶⁹ The *istisna* contract is based on the concept of contract manufacturing, whereby the seller commits to manufacture the commodities or goods for the buyer, based on agreed specifications for the goods given in the contract. To be more precise, a customer gives clearly described or identified specifications to a manufacturer for non-existing goods that are to be manufactured and then delivered on an agreed future date.³⁷⁰ For example, an Islamic bank may be asked to finance the construction of buildings such as residential tower blocks, villas or schools or to manufacture aircrafts, ships, cars, machines or equipment.³⁷¹ Another example is when an Islamic bank finances an aircraft manufacturer to manufacture aircraft for Saudi Arabian airlines in accordance with the specifications given by the airline company. It should be noted in the previous example that the Islamic bank's role is as a financier and intermediary between two parties and it orders the goods on behalf of the customer. However, it may play the role of manufacturer, as in the first example. Generally, the *istisna* contract is useful in aspects of industrial life, such as purchasing equipment from a manufacturer or housing from a developer, and is useful for banks wishing to provide finance for construction.³⁷²

As for the legality of *istisna*, *Shariah* permits the *istisna* contract because, in *Shariah*, everything is lawful unless it is forbidden in the *Quran* and *Sunnah*, and it has been legalised on the basis of the principle of public interest,³⁷³ so the *istisna* contract does not contain anything that is prohibited by *Shariah*.³⁷⁴ In *Surat Al-Kahf* Allah says:

³⁶⁸ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: interest-free or interest-based', *Science Direct* (2009) 17 (1) 129.

³⁶⁹ Brian Kettell, *Islamic Finance in a Nutshell: a Guide for Non-Specialists* (John Wiley & Sons Ltd 2010) 70.

³⁷⁰ Fahim Khan & Mario Porzio, *Islamic Banking and Finance in the European Union: a Challenge Studies in Islamic Finance, Accounting and Governance* (Edward Elgar 2010) 53; Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 10.

³⁷¹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 262.

³⁷² Greg Fealy & Sally White, *Expressing Islam: Religious Life and Politics in Indonesia* (ISEAS Publishing 2008) 238; Fahim Khan & Mario Porzio, *Islamic Banking and Finance in the European Union: a Challenge Studies in Islamic Finance, Accounting and Governance* (Edward Elgar 2010) 53.

³⁷³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 263.

³⁷⁴ *Ibid*, p. 262.

“O Dhul-Qarnayn, indeed Gog and Magog are great corrupters in the land. So may we assign for you an expenditure that you might make between us and them a barrier?”³⁷⁵

With regard to this contract, the renowned contemporary jurist Zuhayli writes:

“*Istisna*‘a evolved into Islamic jurisprudence historically due to specific needs in the areas of manual work, leather products, shoes, carpentry, etc. However, it has grown in the modern era as one of the contracts that make it possible to meet major infrastructure and industrial projects such as the building of ships, airplanes and other large machinery”.³⁷⁶

There are some important points regarding the price, delivery and disposal of the subject matter, which are summarised below:

1. In the *istisna* contract, it is not necessary for the delivery time to be fixed. However, the purchaser may fix a maximum time for delivery.³⁷⁷
2. The price must be specified and known, with the consent of the parties involved, to avoid ignorance.³⁷⁸
3. For the contract to be valid, it must specify the place of delivery.
4. It is not necessary in *istisna* for the bill to be paid in advance. In other words, spot payment of the bill is not necessary. The payment can be paid in instalments according to the completion stages or at different stages of the project, such as paying off a manufacturer at the end of each stage.³⁷⁹
5. The *istisna* contract may be cancelled by any party by giving a prior notification time before starting the manufacturing process, but not after the manufacturer has started the work; because it is a moral obligation on the manufacturer to manufacture the goods and on the purchaser to respect the contract.³⁸⁰

³⁷⁵ See verse 94 of Surah 18 of the Holy Quran.

³⁷⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 262.

³⁷⁷ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 92.

³⁷⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 263.

³⁷⁹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 10.

³⁸⁰ Kabir Hassan and Mervyn Lewis & Mervyn K Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 120; Beng Soon Chong & Ming-Hua Liu, ‘Islamic banking: interest-free or interest-based’, *Science Direct* (2009) 17 (1) 129.

6. Any risk to the goods or assets remains with the seller before delivery, while after delivery it transfers to the purchaser.³⁸¹
7. *Istisna* contracts are used in high technology industries, which need manufacturing, such as the building of locomotives, aircraft and ships.³⁸²
8. In *istisna*, the delivery of the subject matter may take place through constructive possession.³⁸³

In general, the *istisna* contract is similar to *bai salam*. However, there are several points of difference between the *istisna* contract and the *bai salam* contract, which are summarised below.

1. In the case of *istisna*, the subject is always something that needs manufacturing, building and processing, while the object of *bai salam* usually involves agricultural products.³⁸⁴
2. It is not necessary in *istisna* for the bill to be paid in full in advance, so it may be paid in instalments, while in *bai salam*, the buyer must pay the bill in full in advance to the seller at the time of effecting the contract.³⁸⁵
3. In *istisna*, the time of delivery is fixed, while in *bai salam* it is an essential part of the sale.³⁸⁶
4. The *istisna* contract can be cancelled at any time by any party by giving a prior notification time before starting the manufacturing process, while in *bai salam* it cannot be unilaterally cancelled.³⁸⁷

3.7.1.8 Qardh-al-hasan (Benevolent or Interest Free Loans)

Generally, as mentioned before, a loan with interest is forbidden by *Shariah*, and the only loan that is permitted in *Shariah* is called *qard hasan*. *Qard hasan* (a benevolent or interest free loan) is a loan contract between two parties, the lender and the borrower.³⁸⁸ It is applied

³⁸¹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 269.

³⁸² Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 118.

³⁸³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 269.

³⁸⁴ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 139.

³⁸⁵ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 92.

³⁸⁶ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1)10.

³⁸⁷ Jaquir Iqbal, *Islamic Finance Management* (Global Vision Publishing House 2009) 92; Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Kluwer Law International 2002) 89.

³⁸⁸ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1)12.

in Islamic banks as a social service to help the poor, such as needy students or small farmers, so it is considered a kind of gratuitous loan which is given to needy people.³⁸⁹ It is returned at the end of the agreed period without any interest, compensation, gift or share in the profit or loss of the business. Therefore, the receiver of this contract is only required to repay the original amount of the loan without interest.³⁹⁰

With regard to the legality of *qard hasan*, there are many verses in the Holy Quran that illustrate this, and also reports from the prophet Muhammed. Allah has permitted and encouraged his creatures this kind of contract. For example:

Surat Taghabun 64, verse 17 of the Quran: “If you lend to Allah a goodly loan (i.e. spend in Allah's Cause) He will double it for you, and will forgive you. And Allah is most ready to appreciate and to reward, most forbearing”.³⁹¹

Surat Al-Muzzammil 73, verse 20 of the Quran: “lend to Allah a goodly loan, and whatever good you send before you for yourselves”.³⁹²

Surat Al-Baqarah 2, verse 245 of the Quran: “Who is he that will lend to Allah a goodly loan so that He may multiply it to him many times? And it is Allah that decreases or increases (your provisions), and unto Him you shall return”.³⁹³

Surat Al-Hadid 57, verse 18: “Indeed, the men who practice charity and the women who practice charity and [they who] have loaned Allah a goodly loan — it will be multiplied for them, and they will have a noble reward”.³⁹⁴

Qard hasan has been mentioned in the *Sunnah*. Prophet Muhammed says: Whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and Allah will facilitate him in this world and world hereafter.³⁹⁵

³⁸⁹ Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 684.

³⁹⁰ Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future* (World Scientific Publishing Co Ltd 2005) 83.

³⁹¹ See verse 17 of Surah 64 of the Holy Quran.

³⁹² See verse 20 of Surah 73 of the Holy Quran.

³⁹³ See verse 245 of Surah 2 of the Holy Quran.

³⁹⁴ See verse 18 of Surah 57 of the Holy Quran.

³⁹⁵ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 2699* (Darussalaam Publishers 1999) 1082.

The objectives for *qard hasan* are as follows:

1. To help the needy in an attempt to alleviate hardship.
2. To help the poorer sections of society.
3. To encourage people to help each other.
4. To establish a better relationship between the poor and the rich.
5. To effect the mobilisation of wealth among all people in the society.
6. To perform a good deed that is encouraged and appreciated by the Almighty Allah and His messenger.
7. To strengthen the national economy.
8. To help the poor to create new job markets and business ventures by using their merits, skills and expertise.
9. To establish a caring society.
10. To eradicate the unemployment problem in society.
11. To remove social and economic discrimination in society.³⁹⁶

Finally, *qard hasan* is considered the perfect substitute to obtaining a loan without interest from Islamic banks. The main purpose of this contract is that it is humanitarian and charitable. *Qard hasan* is supported by both the *Quran* and *Sunnah*.

3.7.1.9 Tawarruq (Monetization of Commodities)

Tawarruq is one of the distinguished Islamic products to be offered by Islamic financial institutions nowadays.³⁹⁷ In addition, it is also applied in some conventional banks that have Islamic windows³⁹⁸ or are Islamised³⁹⁹ either in Islamic countries (such as SABB, formerly known as the Saudi British Bank in Saudi Arabia, which offers Islamic products by means of an Islamic window), or in Western countries (such as HSBC Bank in the UK, which does so through its window). Such windows are known as *Amanah*. The contract is also known as an organized *tawarruq*, which is considered a new contract in the modern Islamic financial

³⁹⁶ Sudin Haron, 'A comparative study of Islamic banking practices', *J.KAU: Islamic Econ* (1998) 10 (1) 28; Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 684; Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds* (GRIN Verlag 2008) 52; Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 12.

³⁹⁷ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 69.

³⁹⁸ An 'Islamic window' means special facilities offered by conventional banks to provide services to clients who wish to engage in Islamic banking.

³⁹⁹ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 11.

industry. The *tawarruq* contract is suitable for people who wish to obtain money in accordance with *Shariah*, and it usually involves three parties. The first one is an Islamic bank, whose role in this contract is that of an intermediary in all the components of this transaction. Secondly, there is a client who wishes to obtain money. The last one is a supplier.

In order to have a *tawarruq* contract under *Shariah*, the goods should be sold to a third party.⁴⁰⁰ The definition of *tawarruq* is a contract to obtain money, whereby someone buys a commodity on credit, in order to sell it for cash at a lower price to a third party, with the aim of obtaining cash, according to *Shariah*.⁴⁰¹ For instance, in Saudi Arabia, people buy cars on credit, in order to resell them immediately to obtain money, and then invest the money in the Saudi stock market. This contract is becoming increasingly popular in Islamic banks in Saudi Arabia, because it is very easy to obtain cash.⁴⁰²

This contract is legally permissible, based on jurisprudence or rulings known as *fatwa*, which are issued by qualified Muslim scholars and also based on the famous rule in Islamic transactions, that is, that the origin of things is permissibility. The Quran states in the Holy *Quran* in *Surah Al-Baqara*: “Allah has permitted trade and has forbidden interest”.⁴⁰³ Therefore, the conditions of sale are applicable in the *tawarruq* contract. Based on this evidence, it is permitted to apply the *tawarruq* contract in Islamic banks or conventional banks according to Islamic principles. Due to the nature of this contract, which is similar to conventional secured lending, the Islamic banks need to understand that the *tawarruq* contract should be used where necessary to avoid interest, especially when the client’s intention is not to purchase goods, but merely to obtain money.⁴⁰⁴ In general, Islamic banks can adopt any financial contracts that do not conflict with Islamic principles of law, so the *tawarruq* contract is one of the Islamic financing contracts that are adopted by Islamic banks.

In this contract, there is only one agreement between all parties; however, in some other financial contracts there are two agreements such as the Islamic *murabaha* contract, which

⁴⁰⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 349.

⁴⁰¹ Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1)11.

⁴⁰² Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 70.

⁴⁰³ See verse 275 of Surah 2 of the Holy Quran.

⁴⁰⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 349; Hij Siti Faridah Abd Jabbar, ‘Sharia-compliant financial instruments: principles and practice’, *Company Lawyer* (2009) 30 (1) 11.

has two agreements: the primary agreement and the final one. At the primary agreement stage, both parties have the right to cancel the contract.⁴⁰⁵

Tawarruq is favoured by both financial institutions and customers. This is for several reasons. Firstly, *tawarruq* is permitted by Islamic scholars. Secondly, it is an easy way to obtain money, especially for people who want to avoid *riba*; for example, in Saudi Arabia, a client can obtain money through a *tawarruq* contract from an Islamic bank within a few hours and the final reason is that there is no high risk factor in this contract.⁴⁰⁶

In order for this contract to be valid, there are several conditions under *Shariah*, as follows:

1. Avoiding *riba*. This condition is the classic one for all Islamic financing contracts.⁴⁰⁷
2. Ownership of the commodities, whereby the seller must own the goods before he offers them to the buyer.⁴⁰⁸
3. Goods are specified, whereby the seller explains the details of the goods to the buyer, when the buyer does not see them.⁴⁰⁹
4. Possession of commodities, whereby the seller is able to deliver them at the agreed time.⁴¹⁰
5. Details of payment. It is important to mention the manner of payment, whether in one payment or by instalments in the contract.⁴¹¹

Finally, there are some transactions steps for deposit products and financing based on the concept of *tawarruq* as follows:

1. The client applies the financing product based on the *tawarruq* contract to Islamic bank.
2. The Islamic bank buys the commodities, which have been identified by the client.⁴¹²
3. The Islamic bank sells the goods to the customer on deferred payment.⁴¹³

⁴⁰⁵ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 79.

⁴⁰⁶ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: the Case Analysis from Australia* (Brown Walker Press 2010) 320; Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 11.

⁴⁰⁷ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 349.

⁴⁰⁸ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 107.

⁴⁰⁹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 350.

⁴¹⁰ Ibid.

⁴¹¹ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) p. 62-63.

⁴¹² Ibid, p. 72.

4. The client asks the Islamic bank to sell the goods in the market. The role of the Islamic bank here is as an agent of the client.⁴¹⁴
5. The Islamic bank sells the commodities to a third party for cash, and then gives the cash (*wariq*) from the sale of the goods to the client.⁴¹⁵

3.8 Risks of Islamic Finance

Islamic banks, like conventional banks, face a number of risks in their banking operations, but there is a slightly different application between them, due to the nature of *Shariah* principles, which are applied in all Islamic financing contracts.⁴¹⁶ It is obvious that the principles of *Shariah* differ from the principles of the capitalist system which are applied in conventional banks. For instance, *riba* is forbidden by *Shariah*, while it is allowed in conventional banks. Therefore, Islamic financing contracts do not offer the products of conventional banks or establish *riba* windows, due to religious restrictions, while the conventional banks can offer Islamic financing products or establish Islamic subsidiaries simultaneously with their own products through Islamic windows.⁴¹⁷ Consequently, it is possible to say that there are two types of risks in Islamic banks. The first type consists of risks that are similar to those faced by conventional banks. Other risks for Islamic banks involve unique risk characteristics, such as the asset and liability.⁴¹⁸ This type of risk is due to the nature of *Shariah*, which governs all Islamic banking operations. There are several kinds of risks in Islamic financial contracts, such as credit risk, liquidity risk, market risk and operational risk,⁴¹⁹ as explained below.

3.8.1 Credit Risk

Credit risk means the risk of losing a financial reward stemming from a borrower's failure to repay a loan or the borrower's failure to meet a contractual obligation within a specified time

⁴¹³ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 11.

⁴¹⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 350.

⁴¹⁵ Hij Siti Faridah Abd Jabbar, 'Sharia-compliant financial instruments: principles and practice', *Company Lawyer* (2009) 30 (1) 11.

⁴¹⁶ Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 684.

⁴¹⁷ M Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 133.

⁴¹⁸ Ibid, p. 144.

⁴¹⁹ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 131; Anjum Siddiqui, 'Financial contracts: risk and performance of Islamic banking', *Managerial Finance* (2008) 34 (10) 684.

limit.⁴²⁰ In other words, this type of risk is related to the ability of a debtor to repay at the time appointed for repayment according to the contract.⁴²¹ Credit risk is the most common source of risk faced by banks, both Islamic and conventional ones.⁴²² For instance, in the contract, if the borrower defaults on his loan commitments, it leads to a loss for the creditor as a result of the counterparty's delay in payment and, consequently, it becomes a risk for the bank. In order to manage credit risk, therefore, there are three types of policies. Firstly, to reduce the credit risk through examining concentration, lending to connected parties and diversification. Secondly, to ensure that banks have the ability to absorb loan losses. Finally, to measure the risk by classifying the assets that carry the risk.⁴²³ Conventional banks face credit risk in almost all of their operations, because in every case the relationship between the banks and debtors is that of a debtor and a creditor. Therefore, if the borrower has delayed payment of the obligation, the bank adds interest as a result of the delay, while this interest is prohibited by *Shariah*. In addition, Islamic banks have very little experience of the fight against risk compared to conventional banks; therefore, the credit risk in Islamic banks is higher than that in conventional banks.⁴²⁴

In Islamic banking activity, credit risk and exposure arise in connection with the following: In the *murabaha* contract, an Islamic bank delivers the goods or assets before receiving payment; for instance, if a customer wants to buy a car from an Islamic bank, based on using a *murabaha* contract. After the application request, the Islamic bank purchases the car based on the client's promise to buy. After buying the car from the provider, the customer has the right to refuse the delivery of the purchased car.⁴²⁵ In this case, the Islamic bank is exposed to credit risk as a result of the counterparty's delay in payment.

In *musharaka* and *mudarabah* contracts, when the capital involved in one of these contracts is employed in a deferred sale, which is what takes place in most *mudarabah*, the owner of the capital, an Islamic bank, faces an indirect credit risk. In other words, non-payment of the

⁴²⁰ Wim Schoutens & Jessica Cariboni, *Levy Processes in Credit Risk* (John Wiley & Sons Ltd 2009) 3.

⁴²¹ Mohamed Ali Elgari, 'Credit risk in Islamic banking and finance, *Islamic Economic Studies* (2009) 10 (2) 9.

⁴²² Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 29.

⁴²³ Ibid, p. 30.

⁴²⁴ Mohamed Ali Elgari, 'Credit risk in Islamic banking and finance, *Islamic Economic Studies* (2009) 10 (2) 9; Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Ltd 2009) 131.

⁴²⁵ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 126.

share of the Islamic bank by the entrepreneur when it is due causes credit risk for Islamic banks.⁴²⁶ These contracts are considered the highest credit risk in Islamic bank operations.⁴²⁷

In the *salam* contract, there are two ways to face credit risk. The first way is represented as a delivery risk where commodities are not delivered at the agreed time or the goods supplied are not as contractually specified or are not according to the seller's/customer's specifications, after payment is made. In this case Islamic banks are exposed to credit risk through the *salam* contract. The second way is that the *salam* contract gives rise to a commodity debt rather than a cash debt. Both ways expose Islamic banks to credit risk.⁴²⁸

In the *istisna* contract, an Islamic bank faces credit risk if the sub-contractor fails to meet the specifications, the quality standards are not as agreed on with the customer, the supplier defaults in providing the goods at the specified time or the quality is not as contractually specified. In this contract, Islamic banks make advance payment for goods that it will receive on a future date and this is a risk for the bank.⁴²⁹

3.8.2 Liquidity Risk

Liquidity risk is defined as the potential loss to Islamic financial contracts arising from their inability either to meet their obligations or to fund increases in assets as they fall, without incurring unacceptable costs or losses.⁴³⁰ It is considered one of the major causes of bank failure or bankruptcy. However, it plays an essential role in mitigating the expected and unexpected balance sheet fluctuations and providing funds for growth.⁴³¹ With regard to the nature of liquidity risk, it is closely linked to the nature of banking assets and liabilities.⁴³² In general, liquidity occurs when the depositors decide to redeem their deposits but the banks cannot afford it or when the banks decide to terminate the loans but the borrowers cannot afford it.⁴³³

⁴²⁶ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 145.

⁴²⁷ Fahim Khan and Mario Porzio, *Islamic Banking and Finance in the European Union: A Challenge Studies in Islamic Finance, Accounting and Governance* (Edward Elgar 2010) 103.

⁴²⁸ Mohamed Ali Elgari, 'Credit risk in Islamic banking and finance, *Islamic Economic Studies* (2009) 10 (2) 9.

⁴²⁹ Ibid.

⁴³⁰ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 150.

⁴³¹ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 36.

⁴³² Suresh Padmalatha, *Management of Banking and Financial Services* (Pearson Education 2011) 398.

⁴³³ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 154.

There are two types of liquidity risk: funding liquidity risk and market liquidity risk. Funding liquidity risk is defined as the risk that a firm will not be able to efficiently meet both expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the firm.⁴³⁴ Market liquidity risk, however, is the risk that a firm cannot easily offset or eliminate a position at the market price.⁴³⁵

Islamic banks in their present financial contracts carry huge debts as bank assets and face higher risks compared to conventional banks; therefore, liquidity risk in Islamic financial contracts may be more severe than in conventional banks, for the following reasons:

1. Islamic banks cannot borrow money based on interest to cover their needs for liquidity when necessary, due to Islamic religious restrictions, which forbid *riba*.⁴³⁶
2. Islamic banks cannot sell the debt initially, due to the involvement of *gharar* and *riba*.⁴³⁷
3. It is the central bank's role to be a lender of last resort for Islamic banks, as is the case with conventional banks.⁴³⁸
4. Most of the deposits in Islamic banks are in current accounts.⁴³⁹
5. The financial development in Islamic banks is slow; consequently, Islamic banks are not able to raise funds quickly from the markets.⁴⁴⁰

3.8.3 Market Risk

Market risk is defined as the potential for losses due to unfavourable movements in market prices, such as interest rates, commodity prices, exchange rates and other economic and financial variables such as stock prices or housing starts. Consequently, there are four standard market risk factors: interest rates, stock prices, foreign exchange rates and goods prices.⁴⁴¹ This kind of risk is also very important, because commodities will not be sold at

⁴³⁴ Ibid.

⁴³⁵ Ibid.

⁴³⁶ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 37.

⁴³⁷ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 146.

⁴³⁸ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 37.

⁴³⁹ Fahim Khan & Mario Porzio, *Islamic Banking and Finance in the European Union: A Challenge Studies in Islamic Finance, Accounting and Governance* (Edward Elgar 2010) 68.

⁴⁴⁰ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 145.

⁴⁴¹ John Fraser & Betty Simkins, *Enterprise Risk Management: Today's Leading Research and Best Practices for Tomorrow's Executives* (John Wiley and Sons 2010) 239.

prices that may not cover costs; so it is important to focus on this type to avoid financial risks. Islamic banks are exposed to a higher market risk than conventional banks, due to some of the effects, such as the asset-backed nature of their finance instruments.⁴⁴² This risk arises in many Islamic financial contracts, such as in the following:

Murabaha: the *murabaha* contract is exposed to market risk due to the duration of the contract. The nature of the *murabaha* contract is such that the mark-up is fixed for the duration of the contract. Therefore, if the benchmark rate changes, the interest rates on these fixed income contracts cannot be adjusted.⁴⁴³

Salam: this contract is exposed to market risk due to price fluctuations for goods. If the Islamic banks fail to deliver the items, they will need to purchase the same at a higher price from the market to meet their obligations.⁴⁴⁴

Ijarah: in the *ijarah* contract a lessor is exposed to market risk on the residual value of the leased asset in the terms of the lease, which may be lower than the agreed-upon price or rent or if the lessee terminates the lease earlier (by defaulting, during the duration of the contract.)⁴⁴⁵

Foreign exchange: this is exposed to market risk due to its fluctuations and the foreign currency receivables and payables. In other words, it means exchange of money in one country for money in another.⁴⁴⁶

3.8.4 Operational Risk

Operational risk is defined as the risk of loss resulting from the inadequacy or failure of internal events (those related to people and systems) or of external events. In addition, it includes the risk of failure of technology, systems and analytical models. This risk is considered part of the integrated risk.⁴⁴⁷ Operational risk is a recent addition to the list of risks faced by Islamic banks, so operational risk may be high for Islamic banks for several reasons.

⁴⁴² Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 34.

⁴⁴³ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 145.

⁴⁴⁴ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 34.

⁴⁴⁵ Ibid.

⁴⁴⁶ Ibid.

⁴⁴⁷ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 174.

The cancellation risk in some Islamic financial contracts is non-binding, such as in *murabaha* and *istisna* contracts.⁴⁴⁸ There is a shortage of qualified professionals to conduct Islamic financial operations.⁴⁴⁹ Due to the different nature of the business, the environment, certain practices and competition for Islamic banks, there are some programmes such as computer software that may not be appropriate for Islamic banks. This leads to system risks for developing and using informational technologies in Islamic banks.⁴⁵⁰ There may be a failure to comply with *Shariah* requirements, which may have an impact on the income of the Islamic banks.⁴⁵¹ There may be a lack of standardised practices by the *Shariah* boards in different jurisdictions, which causes Islamic banks to be exposed to operational risk.⁴⁵² There is an inadequate internal control system in Islamic banks to detect and manage potential problems in operational processes.⁴⁵³

Islamic banks are exposed to operational risk in some of their forms and these risks differ depending on the types of Islamic financing. For instance, operational risk in *murabaha* and *ijarah* contracts is low, while in *istisna* and *mudarabah* contracts it is high.⁴⁵⁴

To sum up, it could be said that Islamic banks are just as exposed to financial risks in their present contracts as conventional banks are, but the nature of the risks faced by Islamic banks is complex and difficult to mitigate, for several reasons. The first reason is that, unlike in conventional banks, given the trading-based instruments and equity financing, there are significant market risks along with credit risks in Islamic banking. Secondly, risks intermingle and change from one kind to another at different stages of a transaction. For instance, trade-based contracts such as *murabaha*, *salam* and *istisna* and *ijarah* leasing are exposed to both credit and market risks. For example, during the transaction period of a *salam* contract, the bank is exposed to credit risk and at the conclusion of the contract it is exposed to commodity price risk. The third reason is because of rigidities and deficiencies in the infrastructure, institutions and instruments. For instance, there are objections to the use of foreign exchange futures to hedge against foreign exchange risk and there are no *Shariah*-

⁴⁴⁸ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 40.

⁴⁴⁹ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 146.

⁴⁵⁰ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 174.

⁴⁵¹ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 40.

⁴⁵² Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 175.

⁴⁵³ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 40.

⁴⁵⁴ Hennie Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* (The World Bank, Washington 2008) 176.

compatible short-term securities for liquidity risk management in most jurisdictions.⁴⁵⁵ In addition, the risks in Islamic financing contracts depend fundamentally on the type of contracts used, the subject matter of the contracts and the way they are traded. For example, risks in *murabaha* and *ijarah* contracts are lower than risks in *istisna* and *mudarabah* contracts. In general, the risks in Islamic financial contracts may be higher than in conventional finance.

3.9 Islamic Finance in Malaysia

The development of the Islamic banking and financial industry in Malaysia involved several phases beginning in 1983. These developments were also facilitated by the passing of several laws aimed specifically at the regulation of Islamic banking and financial activities such as the Islamic Banking Act of 1983, which was replaced by the Islamic Financial Services Act in May 2013, the Takaful Act of 1984, the Banking and Financial Institutions Act of 1989, the Securities Commission Act of 1993, the Capital Markets and Services Act 2007, the Development Financial Institutions Act 2002 and the Central Bank of Malaysia Act of 2009. Under sub-s 16B (1) of the Central Bank of Malaysia Act 1958 (before the new Act 701 was amended in 2009), the Shariah Advisory Council of Bank Negara Malaysia (SAC) was established in 1997 as the highest *Shariah* authority in Islamic finance in Malaysia.⁴⁵⁶

The SAC has been granted the authority for the ascertainment of *Shariah* for the purposes of Islamic banking business, Islamic financial business, *takaful* business, Islamic development financial business, or any other business, which is based on the principles of *Shariah* and is supervised and regulated by Bank Negara Malaysia (BNM). As the reference body and advisor to BNM on Shariah matters, the SAC is also responsible for validating all Islamic banking and *takaful* products to ensure their compatibility with *Shariah* principles. In addition, it advises BNM on any *Shariah* issue relating to Islamic financial business or transactions of Bank Negara Malaysia as well as other related entities.⁴⁵⁷

In the recent Central Bank of Malaysia Act 2009, the role and functions of the SAC was further reinforced whereby the SAC was accorded the status of the sole authoritative body on *Shariah* matters pertaining to Islamic banking, Islamic finance and *takaful*. While the rulings

⁴⁵⁵ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Ltd 2007) 148.

⁴⁵⁶ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 85.

⁴⁵⁷ See the official website of Bank Negara Malaysia (BNM), <http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802> [Accessed 14 July 2014].

of the SAC shall prevail over any contradictory ruling given by a *Shariah* committee constituted in Malaysia, the court and arbitrator are also required to refer to the rulings of the SAC for any proceedings relating to Islamic financial business and such rulings shall be binding. Under the Central Bank of Malaysia Act 2009, any ruling made by the SAC shall be binding on Islamic financial institutions, the court and arbitrator.⁴⁵⁸ The SAC consists of prominent *Shariah* scholars, jurists and market practitioners, whose members are qualified individuals and have vast experience in banking, finance, economics, law and the application of *Shariah*, particularly in the areas of Islamic economics and finance.⁴⁵⁹

In Malaysia, the central financial authorities are the central bank, Bank Negara Malaysia, and the Securities Commission. At the individual level of the Islamic financial institutions, there is the *Shariah* Board committee. The SAC of Bank Negara Malaysia covers all contracts under Islamic banking and *takaful* whereas the SAC of the Securities Commission covers contracts applied in the Islamic Capital Markets. The *Shariah* standards followed are those of the SAC of Bank Negara Malaysia and of the Securities Commission, which themselves are influenced by both the *Shariah* standards of the AAOIFI and the Islamic Fiqh Academy.⁴⁶⁰

In Malaysia, the establishment of the *Shariah* Committee (SC) is a statutory requirement to all banks which offer Islamic banking products pursuant to section 3 (5) (b) of the Islamic Banking Act of 1983 for Islamic banks, and section 124 (7) of the Banking and Financial Institutions Act of 1989 for the Islamic banking scheme bank. The main objective of the establishment of the SC is to advise the Islamic financial institutions on any *Shariah* matter and also to ensure compliance with the basic principles of *Shariah*. Section 3 (5) (b) of the Islamic Banking Act of 1983 states that the BNM shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless he is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a *Shariah* board.⁴⁶¹

The BNM has issued the BNM/GPS 1 to regulate the governance of SC of Islamic financial institutions. It has also issued the Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks known as BNM/GPS8-i. The BNM/GPS1 consists of 10 parts with 24 sections and one appendix. The contents include objectives, the scope of application,

⁴⁵⁸ Ibid.

⁴⁵⁹ Ibid.

⁴⁶⁰ Kabir Hassan & Michael Mahlke, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 320.

⁴⁶¹ Hjh Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer* (2009) 30 (10) 312-313.

the establishment of the SC, membership, restrictions, duties and responsibilities of the SC and Islamic financial institutions, the reporting structure, effective date and secretariat of the SAC. IFIs had to comply with the guidelines by 1st April 2005 and the dateline was extended to a development financial institution prescribed under the Development Financial Institutions Act 2002 which followed? the Islamic Banking Scheme until 1st September 2005.⁴⁶²

The objective of BNM/GPS 1 is to set out the rules, regulations and procedures in the establishment of the SC, to define the role, scope of duties and responsibilities of the SC and to define the relationship and working arrangements between the SC and the SAC. The BNM/GPS1 shall only be applicable to an Islamic bank licenced under the Islamic Banking Act of 1983, a financial institution licenced under the Banking and Financial Institutions Act of 1989 which participates in the Islamic Banking Scheme, a development financial institution prescribed under the Development Financial Institutions Act 2002 which follows an? Islamic Banking Scheme; and a *takaful* operator registered under the Takaful Act 1984.⁴⁶³

Therefore, Malaysia is considered one of the most advanced Islamic finance industries in the world due to a number of laws and regulations that have been issued by the Government of Malaysia to regulate and supervise Islamic banking and financial activities including *takaful*. In addition, an independent body called the *Shariah* Advisory Council of Bank Negara Malaysia was established in order to verify that all products of Islamic banking, finance and *takaful* comply with the provisions of *Shariah*. In addition, the SAC is also responsible for the legal interpretations of *Shariah*, and its interpretations are considered binding for Islamic financial institutions in Malaysia.⁴⁶⁴ As a result of the existing regulatory and supervisory framework of Islamic banking and financial activities including *takaful* in Malaysia, it has become the indisputable global hub for Islamic finance, particularly in the field of *sukuk*

⁴⁶² Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010 3 (2) 86.

⁴⁶³ Ibid.

⁴⁶⁴ Hjh Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer* (2009) 30 (10) 312.

where it is the world's largest *sukuk* market with a number of Malaysia's *sukuk* issues of 68.9%, or USD 62 billion of the total global outstanding *sukuk* at the end of 2007.⁴⁶⁵

Despite the growth and development of the Islamic banking and finance industry including Islamic insurance (*takaful*) and the Islamic Capital Market in Malaysia, there are some legal obstacles facing this industry. The main legal obstacle is that the nature of disputes of Islamic banking and finance are applied to civil courts. In Malaysia, Islamic financial institutions (IFIs) operate in the environment where the legislative framework consists of mixed jurisdictions and mixed legal systems namely *Shariah* and common law.⁴⁶⁶ According to Hasan, the principles of common law are applied in civil court matters and disputes including Islamic Banking disputes, while Islamic law is only applicable in *Shariah* courts to govern disputes involving family matters and the law of inheritance.⁴⁶⁷ In Malaysia, Islamic banking disputes are applied to civil courts instead of *Shariah* courts so are considered under the item "finance" under the Ninth Schedule of the Federal Constitution of Malaysia.⁴⁶⁸ In addition, Article 121 of the Federal Constitution provides unequivocally that the civil court has jurisdiction over *Shariah* matters with regards to mercantile, Islamic banking, business and commercial issues.⁴⁶⁹ The following example shows that the court applies the common law principles and did not reference the applicable underlying *Shariah* principles in Islamic finance disputes.

The facts of the case of Bank Islam Malaysia Berhad (the plaintiff) v Adnan Omar (the defendant) is that the plaintiff granted the defendant a loan of RM 583,000, secured upon a charge over a certain parcel of land. The plaintiff granted this facility under the Islamic *Bai Bithaman Ajil* (BBA) loan scheme which in effect involved the execution of three simultaneous transactions between the parties, namely (1) the sale of the subject property by the defendant to the plaintiff for RM 265,000 which was duly paid by the plaintiff (2) the plaintiff reselling the same to the defendant for RM 583,000 payable in 180 installments and (3) the defendant executing a charge over the land as security for the said debt of RM 583,000. The defendant defaulted in his payments and the plaintiff accordingly filed an

⁴⁶⁵ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476.

⁴⁶⁶ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 84.

⁴⁶⁷ Ibid.

⁴⁶⁸ The Federal Constitution of Malaysia the Ninth Schedule of 1957.

⁴⁶⁹ Kabir Hassan & Michael Mahlke, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 97.

originating summons under the Rules of the High Court 1980. The High Court held that the defendant was bound to pay the whole amount of the selling price based on the grounds that he knew the terms of the contract and knowingly entered into the agreement. In this respect, the court applied the classic common law interpretational approach where the parties are bound by the terms and conditions of the contract. The court did not look further into the issue as to whether the *Bai Bithaman Ajil* (BBA) facility involved an element not approved by the *Shariah* as stipulated under the Islamic Banking Act 1983 and the Banking and Financial Institutions Act 1989.⁴⁷⁰

However, there is an initiative which has been formulated by the Central Bank of Malaysia with the cooperation of the judicial civil body to set up a special High Court in the Commercial Division of the civil court system known as the *Muamalah* bench to deal exclusively with IFIs and any disputes arising under Islamic Banking.⁴⁷¹

Overall, Malaysia is considered to be the world's most important Islamic finance centre due to a strong legal and *Shariah* framework for Islamic finance. Therefore, it is possible to transfer the unique Malaysian experience in the field of Islamic finance to Saudi Arabia for several reasons. First, Malaysia has issued a series of laws and regulations to regulate all operations of Islamic finance in Malaysia, whereas, in Saudi Arabia there are no specific laws governing Islamic finance products. Secondly, Malaysia established the *Shariah* Advisory Council of Bank Negara Malaysia as the highest *Shariah* authority in Islamic finance in Malaysia to ensure that all operations of IFIs are in compliance with *Shariah*. On the contrary, in Saudi Arabia, there is no independent central *Shariah* board to regulate and supervise IFIs and as a result, IFIs are free to adopt their own *Shariah* governance. In addition, Bank Negara Malaysia has issued uniform *Shariah* standards for the Islamic financial industry as well as it adopted AAOIFI's standards and guidelines for the Islamic financial industry. The Saudi central bank (SAMA) did not issue such standards and guidelines that regulate the Islamic banking business in Saudi Arabia nor did they adopt the standards issued by international bodies specialising in the field of Islamic finance such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). Therefore, the researcher believes that the transfer

⁴⁷⁰ Zulkifli Hasan & Mehmet Asutay, 'An Analysis of the Courts' Decisions on Islamic Finance Disputes', *ISRA International Journal of Islamic Finance* (2011) 3 (2) 44.

⁴⁷¹ Ibid.

of the Malaysian experience in the field of Islamic finance to Saudi Arabia would have a positive impact on the development of the legal structure of Islamic finance in Saudi Arabia.

3.10 Challenges of Islamic Finance

Islamic finance has evolved and expanded in a fast-changing and dynamic international environment. In the context of a more challenging and competitive environment, issues of financial stability, viability and competitiveness are paramount.⁴⁷² It has also made substantial progress over the last three decades after the establishment of the first Islamic bank (Dubai Islamic Bank) in 1975. The number of institutions offering *Shariah*-compliant services has risen, as has the number of conventional banks that have opened Islamic banking windows as banks have rushed to satisfy the appetite of investors and consumers for *Shariah*-compliant products to finance assets from cars and houses to aircraft and project finance. The total volume of assets that all these institutions manage has risen rapidly and so has the international acceptance of Islamic finance.⁴⁷³ It could be said that the results and health growth of the Islamic financial industry compared to those of the conventional banking industry during the recent global economic crisis that commenced in 2007 are clear evidence that the rules and principles representing the foundation of Islamic banks are solid and valid.⁴⁷⁴ The soundness and viability of Islamic finance as a form of financial intermediation are premised on the fundamental requirement that Islamic financial transactions be supported by an underlying productive activity. There is always, therefore, a close link between financial and productive flows. A financial transaction must be accompanied by genuine trade or lease-based and business-related transactions wherein interest is eliminated and profits or rentals are the economic rewards. Alternatively, an Islamic financial institution may provide financing for a venture by becoming a joint partner based on a pre-specified profit sharing arrangement. In addition, Islamic finance also sets explicit restrictions on unethical and speculative financial activities.⁴⁷⁵ However, the Islamic financial industry is still in its formative stage and faces a number of challenges that need to be addressed to enable it to continue its rapid expansion without facing any serious crisis and, thereby, acquire greater

⁴⁷² Mercy Kuo, 'Islamic finance: global trends and challenges', *National Bureau of Asian Research* (2008) 18 (4) 9.

⁴⁷³ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 325.

⁴⁷⁴ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 184.

⁴⁷⁵ Mercy Kuo, 'Islamic finance: global trends and challenges', *National Bureau of Asian Research* (2008) 18 (4) 9.

respectability and a much greater share of the international financial market.⁴⁷⁶ These important challenges facing the Islamic banking industry are identified as follows.

The first challenge is the lack of standard interpretations of the same issue due to the multiplicity of *Shariah* boards and different opinions of Islamic scholars in relation to each bank. This in turn leads to a lack of homogeneity for some products on the one hand, and to uncertainty on the part of clients as to whether a product developed in one jurisdiction is *Shariah*-compliant in a neighbouring jurisdiction. This difference of opinion among Muslim scholars is known as *ijtihad* in *Shariah*. In addition, Islamic finance laws and regulatory practices vary across countries and, therefore, this challenge is the most important one for Islamic banking.⁴⁷⁷ For instance, *Shariah* boards in Islamic banks usually ask four questions in relation to any given transaction: Do the terms of the transaction comply with *Shariah* law? Is this the best investment for the client? Does the investment produce value for the client and for the community or society in which the client is active? As an asset manager, is this a transaction in which the banker as an individual would be prepared to invest his own money?

If the answer to any of these four questions is no, the proposed transaction will usually be rejected. Consequently, it is important to stress that Islamic finance is based on the principles of *Shariah* in all practices, in order to ensure the integrity and credibility of the Islamic banking industry.⁴⁷⁸

The second challenge is developing benchmarks. Islamic financial institutions require benchmarks for the pricing of goods and services and for determining sharing ratios for the distribution of profit among the partners of joint ventures. For the time being, conventional benchmarks are being used by IFIs in almost all jurisdictions, whereas these benchmarks are not easily available in Islamic banks.⁴⁷⁹

Thirdly, the conventional banking sector is supported and regulated by the central bank. For instance, the central bank supports commercial banks by giving them discount rates on loans, and it also regulates commercial banks. In contrast, Islamic banks do not receive support

⁴⁷⁶ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 325.

⁴⁷⁷ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 184.

⁴⁷⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 476.

⁴⁷⁹ *Ibid.*, p. 477.

from central banks in their countries.⁴⁸⁰ Islamic banks also need some facility akin to the lender-of-last resort, which is available to conventional banks, to overcome liquidity crises when these occur suddenly as the result of unforeseen circumstances.⁴⁸¹

Fourthly, Islamic financial institutions are challenged to offer a better customer service that matches international standards and also to invest in effective technology, such as using the internet to create new distribution channels to reach more customers. Such concepts as quality and creating value for customers are central to the success of banks entering the Islamic market today.⁴⁸²

Fifthly, proponents of Islamic finance are concerned about the current environment and future regulatory regimes in terms of the treatment of conventional banks versus the treatment of Islamic banks. Separate supervision and regulation of Islamic banks have yet to take hold in most countries; only Kuwait and Bahrain operate separate regulatory regimes for the sector at this time. In most markets, Islamic banks follow the standards set by local regulators for conventional banks, even if those standards are not always appropriate for Islamic institutions.⁴⁸³

Sixthly, Islamic banks suffer from a shortage of skilled and well-trained professionals, which limits their ability to compete and expand their market share. The industry needs new talent and needs to retrain conventional bankers in the practices of Islamic banking.⁴⁸⁴

Seventhly, discipline and transparency are serious issues of concern in Islamic banks. Despite the requirement of disclosure to promote transparency and market discipline issued by the Islamic Financial Services Board in 2007, it appears that the majority of banks are not adhering to it.⁴⁸⁵

⁴⁸⁰ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011)184.

⁴⁸¹ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007)335.

⁴⁸² Bala Shanmugam & Zaha Rina Zahari, *A Primer on Islamic Finance* (The Research Foundation of CFA Institute 2009)95.

⁴⁸³ Ibid.

⁴⁸⁴ Ibid.

⁴⁸⁵ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 184.

Finally, Islamic financial institutions need to increase investment in research and development, including products and mechanisms related to risk management.⁴⁸⁶

To sum up, despite the many challenges facing the Islamic finance industry at the present time, the future looks promising indeed.⁴⁸⁷ There is no doubt that Islamic financial institutions have firmly established a solid foundation in international financial transactions. Currently, there are more than 500 Islamic banks and institutions in 75 countries in the world and the assets of Islamic financial institutions have reached 7500 billion dollars.⁴⁸⁸

3.11 Summary

This chapter has reviewed the body of knowledge concerning Islamic finance laws, principles, distinguishing features, contracting forms, risks and challenges from an Islamic point of view. It has highlighted the main question of this research through a review of Islamic financial contracting forms, which are applied in Islamic banks or through Islamic windows in conventional banks. It has also reviewed the practice of Islamic finance in Malaysia, its legal system, its strengths and weaknesses and how to transfer the Malaysian experience to Saudi Arabia.

This chapter concluded by explaining that Islamic finance is based on principles of *Shariah*, and involves the sharing of profits and losses. Islamic finance includes a set of financial contracts which are compatible with *Shariah* principles. *Shariah* derives its provisions from the Holy *Quran* and *Sunnah* of Prophet Muhammad. In addition to the *Quran* and *Sunnah*, there are also secondary sources, namely *Ijma* and *Qiyas*. Islamic financial contracts are offered by Islamic banks and the Islamic banking windows in conventional banks. The major financial principles of *Shariah* are the prohibitions on interest (*riba*), either *riba an-Nasia* or *riba al-Fadl*; gambling (*qimar/maisir*) and uncertainty (*gharar*).

After the above comprehensive review of the literature on Islamic financial contracting forms, the researcher will investigate three types of Islamic finance in Saudi Arabia; namely, Islamic bonds (*sukuk*), Islamic insurance (*takaful*) and Islamic financial derivatives, as he

⁴⁸⁶ Bala Shanmugam & Zaha Rina Zahari, *A Primer on Islamic Finance* (The Research Foundation of CFA Institute 2009) 95.

⁴⁸⁷ Ibid, p. 97.

⁴⁸⁸ Mohammad, AL-Rawashdah, 'The political and financial implications of globalization on the Islamic banking: facts and events', *European Journal of Social Sciences* (2009) 12 (2) 189; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 15.

believes that examining only one type does not adequately reflect the legal aspect of Islamic financing contracts in the kingdom, due to the multiplicity of its laws and regulatory bodies. Thus, the three types mentioned above have different laws and regulations, as well as different supervisory authorities. In addition, they have a multiplicity of quasi-judicial committees to address banking matters. Therefore, *sukuk*, *takaful* and Islamic financial derivatives will be described in greater detail in separate chapters, in order to investigate whether these three types of Islamic finance in Saudi Arabia are compatible with the principles of *Shariah*.

The regulatory framework of *sukuk* issuance in Saudi Arabia will be discussed in detail in the next chapter, which will also examine whether the current uses of *sukuk* provided by the CMA are compatible with the principles of *Shariah*.

CHAPTER FOUR: SUKUK ISSUANCE AND ITS REGULATORY FRAMEWORK IN SAUDI ARABIA

4.1 Introduction

This chapter aims to give a comprehensive and critical review of *sukuk* issuance in Saudi Arabia, and the extent to which the issuance of *sukuk* in Saudi Arabia is consistent with *Shariah* requirements. The chapter is divided into a number of sections. Accordingly, the first section of this chapter begins with an examination of *sukuk* in general, and includes the concept of *sukuk*, its basic principles, common types of it, and a critical analysis of the most important differences between *sukuk* and conventional bonds. The second section provides a critical analysis of how *sukuk* work in Saudi Arabia, presenting the regulatory framework of the issuance of *sukuk* in Saudi Arabia, and the legal challenges from the *Shariah* point of view, and providing recommendations to overcome these challenges. A summary is provided at the end of the chapter.

4.2 The Concept of Islamic Bonds (*Sukuk*)

The term *sukuk* is a plural Arabic name for Islamic financial certificates and is equivalent to a bond. The singular of this term is *sakk*. The term *sukuk* was used in Muslim societies during the Middle Ages, and refers to ‘papers’, which are undertaken for financial obligations originating from trade and other commercial activities. However, the concept of *sukuk* has undergone profound changes with regard to its conventional structure. In terms of market parlance, *sukuk* refers to negotiable financial instruments which do not consist of elements that have been prohibited in Islam.⁴⁸⁹

In May 2003, *sukuk* was defined officially by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as certificates of equal value, which represent an undivided pro-rate ownership of underlying assets, and the *sakk* can be freely traded at par premium or discount. In Islamic finance, *sukuk* represents a ‘capital market corollary to a singular lender’.⁴⁹⁰ It refers to the bonds which are in compliance with *Shariah* principles.

⁴⁸⁹ Michael J. T. McMillen, ‘Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years’ *Wisconsin International Law Journal* (2010) 25(4) 707; S.R. Vishwanath and Sabahuddin Azmi, ‘An Overview of Islamic Sukuk Bonds’, *The Journal of Structured Finance* [2009] 58-59.

⁴⁹⁰ Noor Inayah Yaakub, Hafizuddin Shah, Wan Kamal Mujani, Kamaruzaman Jusoff and Mohamad Abdul Hamid, ‘Asset Ownership and Investor’s Protection under Sukuk Ijarah’ *Middle East Journal of Scientific Research* [2011] 23.

Due to Islamic religious beliefs, charging or paying interest (*riba*) as a source of earning profits is considered immoral. This belief has made it mandatory for financial institutions to earn a profit on the basis of real economic activity. *Shariah* law also prohibits investment in a number of sectors including alcohol, gambling and armaments, excessive uncertain trade contracts (*gharar*), tobacco, trading in debt contracts at discount, and gambling and chance-based games (*qimar*).⁴⁹¹ This is because of the lessons of the Quran. Therefore, in Muslim-populated countries, a traditional debt market cannot flourish, as conventional bonds represent interest-based funding.

The law prohibits ‘enrichment of trade from debt’ and ‘interest on loans’. Therefore, the sale of accounts receivables is not compatible with *Shariah* law, as it does not involve real assets. However, the law permits securitisation of non-financial assets, such as *ijarah* assets and *bai’ salam* assets, and underlying assets pool within a *mudarabah* or a *musharakah* structure. It is permitted to securitise *ijarah*, as in this case, the underlying assets are the real collateralised *ijarah* and generate cash flows from lease payments. It is quite common to create a Special Purpose Vehicle (SPV) in an *ijarah* financing system, which can be used to issue a *sukuk-al-ijarah* or *ijarah* certificate to investors. The SPV (lessor) leases to a particular company (lessee) and this company utilises the assets in its production.⁴⁹²

The lessor SPV receives a periodic payment by the lessee company and the lessor provides a portion of the payment to the suppliers. The certificate holders also receive a portion of the proceeds as a predetermined return on investment. The sum of the periodic rental payments from which the return is secured is agreed between both parties, which are the lessor SPV and the lessee company; this is why the certificate is capable of giving its holder a predetermined rate on investment. However, the return on investment is low, because the *sukuk al-ijarah* fund is a low-risk fund with a minimum risk of capital loss.⁴⁹³

⁴⁹¹ Andreas A. Jobst, ‘The Economics of Islamic Finance and Securitization’ *Journal of Structured Finance* (2007) 13(1) 3; S.R. Vishwanath and Sabahuddin Azmi, ‘An Overview of Islamic Sukuk Bonds’, *The Journal of Structured Finance* [2009] 58.

⁴⁹² S.R. Vishwanath and Sabahuddin Azmi, ‘An Overview of Islamic Sukuk Bonds’, *The Journal of Structured Finance* [2009] 60-61; Andreas A. Jobst, ‘The Economics of Islamic Finance and Securitization’ *Journal of Structured Finance* (2007) 13(1) 4-5; Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, ‘The Effectiveness of Sukuk in Islamic Finance Market’ *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 473.

⁴⁹³ S.R. Vishwanath and Sabahuddin Azmi, ‘An Overview of Islamic Sukuk Bonds’, *The Journal of Structured Finance* [2009] 59.

4.3 An Overview of the *Sukuk* Market

In 1990, Malaysia became the first country to issue *sukuk*, with a small amount of (Ringgit Malaysia RM120 million) (U.S. \$30 million) by Shell Malaysia. Over a decade and a half, the capital raised through *sukuk* has increased manifoldly. In 2004, it was U.S. \$6.7 billion, whereas in the first six months of 2005, the total reached U.S. \$6.2 billion. It is worth emphasising here that in the year 2007, about \$10.43 billion of *sukuk* was listed on the Dubai International Financial Exchange (DIFX), which was the highest of any exchange worldwide.⁴⁹⁴

An impressive rise in the amount of *sukuk* was observed during the year 2006-2007, when the global market value of *sukuk* reached \$51.5 billion in 2007; this figure was up by 90% compared to 2006. The data indicate that there had been a tremendous increase in the global *sukuk* market, and according to the International Monetary Fund (IMF), this boost was expected to build up an impetus in the days ahead. The volume of *sukuk* issued worldwide was equal to \$47 billion in 2007, which was 73% up from the figure of 2006. The volume of capital rose through *sukuk* in the Middle East, particularly in the countries of the Gulf Cooperation Council (GCC); it reached \$53 billion from \$38 billion in 2007. The total number of *sukuk* issued worldwide also saw a significant rise, reaching 207 in 2007, as compared to 199 in 2006 and 89 in 2005.⁴⁹⁵

4.4 Differences between *Sukuk* and Conventional Bonds

Sukuk bonds are differentiated from conventional bonds on the basis of contract legitimacy and *Shariah*-compliances.⁴⁹⁶ There are no such differences in terms of financial perspectives. The similarity of *sukuk* with conventional bonds has made it very popular in the conventional finance industry. *Sukuk* and conventional debt instruments share many common features, especially asset-backed bonds. When it comes to rating, default clauses, and coupon payments, Cakir and Raei see *sukuk* as parallel to conventional bonds.⁴⁹⁷

⁴⁹⁴ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 59.

⁴⁹⁵ Ibid.

⁴⁹⁶ Muhammad Al-Amine, 'Sukuk Market: Innovations and Challenges', *Islamic Economic Studies* (2008) 15 (2) 8.

⁴⁹⁷ Selim Cakir and Faezeh Raei, 'Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk?' *International Monetary Fund* (2007) WP/07/237, 3-4.

In the case of the bond, there is a contractual debt obligation under which the issuer is obliged to pay a certain interest on a specified date. On the other hand, *sukuk* enables the bondholder to claim an undivided beneficial ownership in the underlying assets. *Sukuk* holders are entitled to share the profits generated through underlying assets with regard to their contribution.⁴⁹⁸ This can be expressed as one of the major distinctions between *sukuk* and conventional bonds.

The following differences have been identified by Thomas and Adam⁴⁹⁹ between *sukuk* and conventional fixed income products:

a) The Issue of Ownership

The ownership of *sukuk* is consistent with the laws of *Shariah*, and symbolises an ownership which is characterised by originating the cash flows/revenues for funding those projects that add genuine value to the economy, and therefore, the community. In terms of their characters and application, the underlying assets must show compliance with *Shariah* laws. The values of underlying assets are not subject to appreciation or depreciation of market values, until the end of the investment cycle. This form of financing is quite helpful in highlighting the importance of genuine assets and assists in minimising the extent of speculation. However, in the case of standard conventional bonds, the authorised borrowers owe the debt to the bond holders, and are contractually obliged to repay the amount of the principal along with interest on maturity.⁵⁰⁰

As regards the principles of Islam, this scenario of the bond is a case of social and economic exploitation. The ownership of a bond is not supported by the value of the underlying assets; rather it is solely supported by the creditworthiness of the issuers. Moreover, the minimal transparency associated with bonds is considered an unhealthy practice which intensifies the volatility in the capital market. In Islam, those sources are considered unethical and exploitative which ensure the return of interest as well as principal.⁵⁰¹ According to Justice Taqi Usmani, a noted *Shariah* scholar, bond-holders in conventional financial institutions are

⁴⁹⁸ Abdul Karim Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (Routledge 2011) 101; Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfaharatul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; *ibid* 458.

⁴⁹⁹ Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2004) 52-53.

⁵⁰⁰ *Ibid*.

⁵⁰¹ *Ibid*.

nothing more than sponsors of enterprise, and the interest charged on their loans can be described as a percentage pegged to the price of interest in the market. It is worth noticing here that a bond can be issued for a wide range of projects, irrespective of its compliance with *Shariah* law.⁵⁰²

b) The Risk/Return Issues

There is a natural tendency by investors to try to minimise their risks, while maximising their return. In this regard, the inherent quality of Islamic finance, which promotes a profit-loss sharing purpose on underlying assets, rather than interest on principal, can be described as the basis of participatory and cooperative joint ventures. Due to the high volatility in return, many investors perceive that bonds are a conservative source of investment. However, the overall return with regard to a bond is subject to many financial variables including interest risks and downturn in the bond prices.⁵⁰³

Moreover, the absence of collateral and risk of defaulters are considered to be major risks associated with bonds. When these issues are compared with *sukuk*, it can easily be observed that in terms of risk/return structures, *sukuk* are broadly analogous to bonds. It has been argued by Usmani⁵⁰⁴ that *sukuk* are indistinguishable from bonds in terms of their return from the projects, on the basis of the London Interbank Offered Rate (LIBOR) benchmark. The inclusion of mandatory underlying assets to reduce risk exposure makes a better risk profile in the case of *sukuk* than in that of bonds.⁵⁰⁵

⁵⁰² Kalid Alsaheed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 35.

⁵⁰³ Aniss Boumediene, 'Is credit risk really higher in Islamic banks?' *The Journal of Credit Risk* (2011) 7 (3) 99; Khadidja Khaldi and Amina Hamdouni, 'Islamic Financial Intermediation: Equity, Efficiency and Risk' *International Research Journal of Finance and Economics* [2011] 65, 149; Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 399-400.

⁵⁰⁴ Sheikh Muhammad Taqi Usmani is one of the contemporary scholars who have a significant role in applying Islamic law to finance. He is an expert in the fields of Islamic Jurisprudence (*fiqh*) and economics, and currently leads the International *Shariah* Council for the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain. He is also deputy chairman of the International Islamic *Fiqh* Academy of the Organization of the Islamic Conference, one of the highest legal bodies in the Muslim World. Usmani is on the *Shariah* advisory boards of HSBC, Dow Jones and Abu Dhabi Islamic Bank, to check that their activities comply with *Shariah*.

⁵⁰⁵ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2004) 54; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 58-59.

The most important difference between *sukuk* and conventional bonds can be identified with regard to the future flow of money. In the case of conventional bonds, investors are assured a fixed rate of return or interest at the maturity of bond. This can be illustrated by an example: an investor who subscribes for bonds worth about £1000 at the rate of 10% will be given the benefits of £100 until the maturity. In other words, the methods for calculating profit for *sukuk* and conventional bonds are the same, except that *sukuk* ensures the benefits on underlying assets rather than on future cash flows. The financial structure of *sukuk* is based upon the exchange of those assets that have been approved with a few scales, instead of the exchange of money with the certificates alone. The *sukuk*-based transactions thus enable investors to receive profits with regard to their investments.⁵⁰⁶

The second major difference can be recognised in terms of financial situations where a bond issuer cannot repay the debt and interest to the investors; in these financial circumstances, a bond holder may lose his/her investment, as the contractual obligations of a bond do not guarantee the security of recovering the principal investment. In the case of *sukuk*, investors can claim some of their investment through collateral to the *sukuk* contract. In addition to this, it ensures that in the case of money raised from investors which has been used to buy a property, the benefits of the assets are distributed among the investors.⁵⁰⁷

⁵⁰⁶ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 204.

⁵⁰⁷ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 476; Noor Inayah Yaakub, Hafizuddin Shah, Wan Kamal Mujani, Kamaruzaman Jusoff and Mohamad Abdul Hamid, 'Asset Ownership and Investor's Protection under Sukuk Ijarah' *Middle East Journal of Scientific Research* [2011] 27.

Table 4.1 Islamic *Sukuk* versus Conventional Bonds

Conventional Bonds	Islamic <i>Sukuk</i>
From the issuer's point of view, it represents a debt obligation to the investors.	It represents stakes of ownership in underlying assets.
Regardless of the compliance with Islamic and non-Islamic purposes, bonds can be issued.	The issuance of <i>Sukuk</i> must be consistent with Islamic financial laws.
It establishes a relationship which can be characterised as that of lender/borrower, with the purpose of earning money on money.	The contractual obligations of <i>Sukuk</i> are permissible Islamic contracts and reflect the characteristics of undertaking business between the <i>Sukuk</i> holders and the originator.
It enables fixed or variable rates of interest on investments.	The tangible assets or services of <i>Sukuk</i> represent legal/beneficial interest in projects.
The sale of a bond is equivalent to a sale of debt.	It enables the sale of a share from the underlying assets.
The creditworthiness of the bond holder is the most important factor in the issuance of conventional bonds, and bond holders do not rely directly on specific assets.	The value of <i>Sukuk</i> prices are driven by and dependent upon fluctuations of market in terms of appreciation and depreciation of the market value of the underlying assets.

Source: An Overview of Islamic *Sukuk* Bonds (2009).

4.5 Common Types of *Sukuk*

There are different types of *sukuk*, which can be arranged and ordered in the form of different financial transactions. Conventional bonds involve assurance about the repayment of a loan, while *sukuk* offer a mechanism of partial ownership under a financial obligation (known as *sukuk murabaha*), business (*sukuk al musharaka*), investment (*sukuk al istithmar*), project (*sukuk al istisna*), and asset (*sukuk al ijarah*).⁵⁰⁸

⁵⁰⁸ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic *Sukuk* Bonds', *The Journal of Structured Finance* [2009] 60.

4.5.1 Ijarah Sukuk

Ijarah sukuk constitute the financial arrangement for durable assets associated with an *ijarah* contract, which includes securities having equal value. They constitute the framework of leased assets and do not establish an association among *sukuk* holders and any company. They are freely tradable at par, premium, or discount in both primary and secondary markets as determined by market forces. A total of three parties are involved in *ijarah sukuk*, namely the originator or beneficiary, the SPV (special purpose vehicle) and *sukuk* holders (investors). It is essential for the terms of agreement to be clearly defined in an *ijarah* contract.⁵⁰⁹

The structure of *ijarah sukuk* involves the following steps. The originator delivers the assets to the SPV on a specified and defined purchase price. *Sukuk* certificates are issued by the SPV for raising funds, which are handed to the originator. With a pre-defined time, the SPV and originator enters into a lease agreement in which the originator acts as lessee by giving back the assets. Regular rental amounts are received by the SPV from the originator, which are dispersed to the *sukuk* holders. The SPV sells back the assets on maturity at their pre-defined value.⁵¹⁰

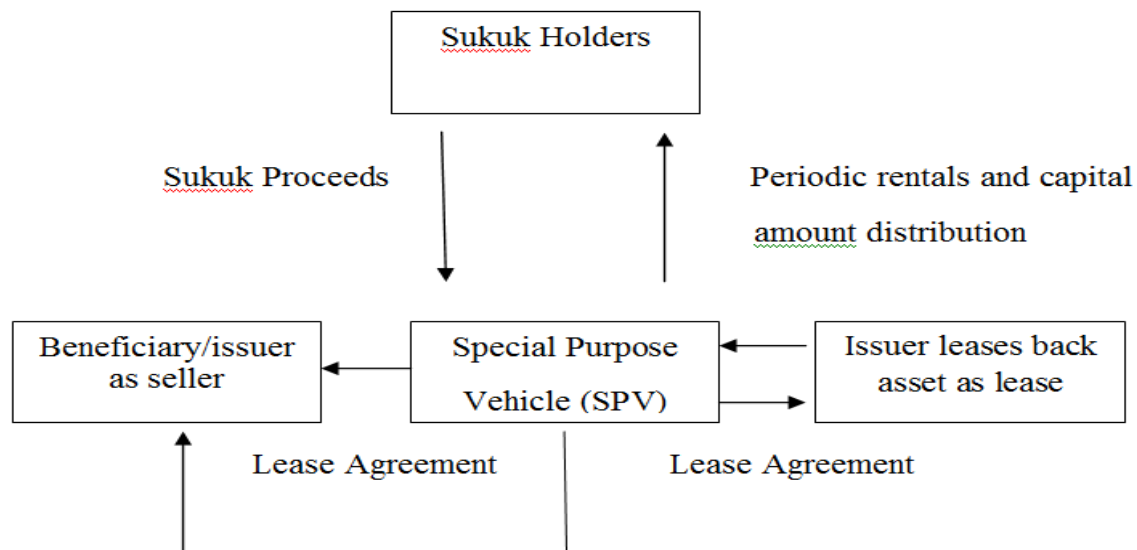
An example of *ijarah sukuk* is Qatar Global *Sukuk*. In October 2003, the Qatar Global *sukuk* were introduced into the market, with a value of \$700 million, and were redeemable in the year 2010. The securities were distributed at a minimum value of \$10,000 with a maturity period of 7 years. Returns on investment have been variable under these securities; these are evaluated in terms of dollar funds London Interbank Offered Rate (LIBOR) and 40 basis points annually. Returns are included as rents on real inherent assets (leased piece of land).⁵¹¹

⁵⁰⁹ Andreas A. Jobst, 'The Economics of Islamic Finance and Securitization' *Journal of Structured Finance* (2007) 13 (1) 20; S.R. Vishwanath & Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 60.

⁵¹⁰ Kalid Alsaheed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 49.

⁵¹¹ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 61.

Figure 4.1 The Structure of *Ijarah Sukuk*



Source: An Overview of Islamic Sukuk Bonds (2009).

4.5.2 Musharakah Sukuk

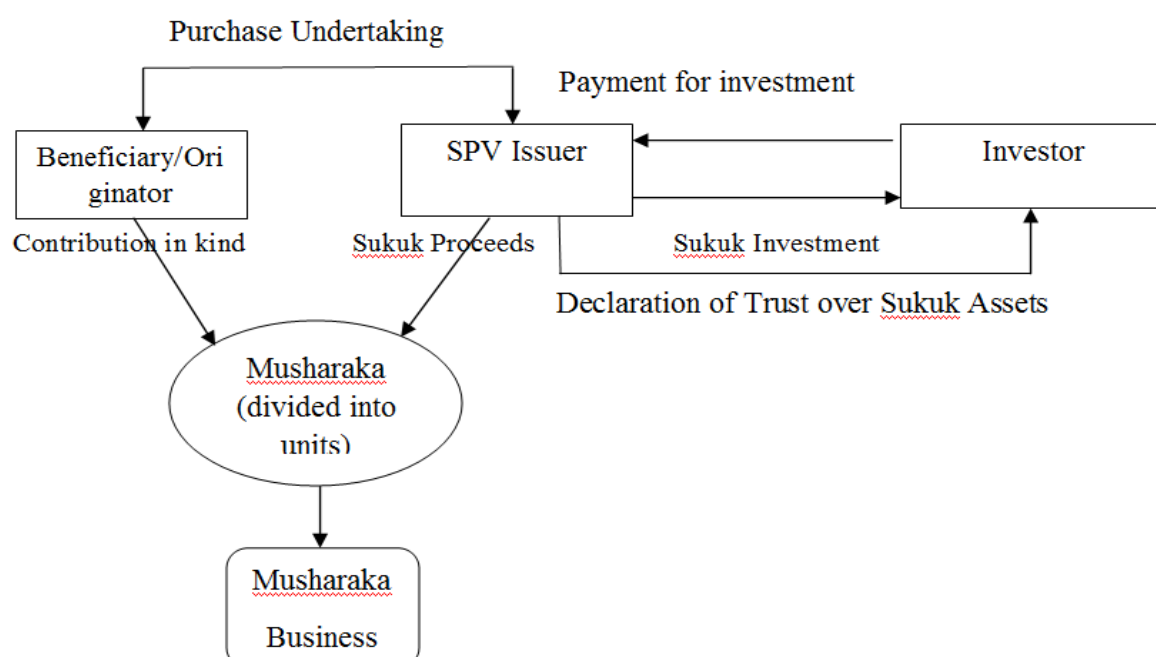
Musharakah sukuk are issued in the market for the mobilisation of funds, so as to facilitate the establishment of new projects, make improvements in existing projects and finance the activities of business (with certificate holders as owners). These are documents with equal value, which are considered to be negotiable instruments that can be traded in secondary markets. Under this mechanism, the originator and SPV participate to form an agreement which is based on a specific period (5 to 7 years) and a pre-defined profit-sharing ratio. *Musharakah* shares are purchased by the corporation at regular intervals from the SPV. The corporation contributes its assets to the agreement and *sukuk* proceeds are contributed by the SPV. The corporation acts as the key agent for the development of land with the funds available from the *musharakah*, so as to sell them on obtaining fixed amount of fees and a variable incentive fee. Profits obtained from this mechanism are disseminated among the *sukuk* holders. In a *musharakah*, by the end of the specified period, there are no shares with SPV.⁵¹²

An example of *musharakah sukuk* is the Emirates *sukuk*. They were issued by Wings FZCO at a value of approximately \$550 million at the rate of 75 basis points on LIBOR, having a

⁵¹² Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization', *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 395-396.

maturity of 7 years. The key objective for the *musharakah* was to establish a new headquarters and engineering centre in Dubai. Regular payments for *sukuk* certificates were made from the rental money obtained from the *musharakah*.⁵¹³

Figure 4.2 The Structure of *Musharakah Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

4.5.3 Mudarabah Sukuk

Mudarabah sukuk, as described by the AAOIFI, refers to a certificate issued in the holder's name and represents the units owned by the holder in the *mudarabah* equity. The holders of the certificate are known as *Rabbul Maal* and the returns of shares in the *mudarabah* equity depend upon the ownership of shares.⁵¹⁴

A formal conclusion of a legally created *mudarabah* contract forms the basis of the *mudarabah sukuk*. It includes the labour and capital provided by both parties, while the

⁵¹³ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 46.

⁵¹⁴ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market', *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 473; Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization', *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

division of profit between the parties is predefined. The *mudarabah sukuk* enable their holder to obtain his capital, as and when the *sukuk* are submitted, and also to collect a fixed proportion of profits declared in the issuance publication. The prime purpose of issuing *sukuk* is to provide monetary support to a finance-generating project or any activity distinct from the general business activities. The profit generated from these separate business activities is distributed according to the agreed percentage. The contract may specify the proportion of the company's earnings that are to be given to the *sukuk* holders in order to return their investments in instalments. It may also mention *sukuk* that are to be retired in the future, along with their market price.⁵¹⁵

Mudarabah sukuk are a significant method of investment, aimed at raising funds. They refer to a document that is given to the holder against the amount of funds paid to the owner of the project. However, *sukuk* do not entitle their owner to make claims with respect to any annual interest. In other words, *mudarabah sukuk* can be regarded as shares with varied returns, accumulated periodically, in accordance with the profits of the project. It is essential for the *mudarabah sukuk* to entitle their owner or holder to shares, as specified in the *sukuk*. The holder of the *sukuk* is entitled to various rights determined by *Shariah* at the time of forming the *mudarabah sukuk* with respect to mortgage, sale, succession, and gifts. Subscription for the *mudarabah sukuk* implies approval on behalf of the issuer and an offer on behalf of the investor. It is necessary for the *mudharabah* contract to be in accordance with the *Shariah*.⁵¹⁶

The *sukuk* holder has the right to sell or transfer his ownership in the securities market on the expiration of a certain pre-determined time period from the time of subscription.⁵¹⁷ However, the sale of *sukuk* must comply with the following conditions. Trading of *sukuk* involving the transfer of *mudarabah* capital in terms of money should be in accordance with the rules of exchange of money (*Sarf*). If the *mudarabah* capital is in the form of debt, the transfer should be in accordance with the principles of Islamic debt trading. If the *mudarabah* capital is in the

⁵¹⁵ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 63.

⁵¹⁶ Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

⁵¹⁷ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishaka and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 474.

form of money, debt, benefits or assets, trade should be conducted according to the market price determined by mutual consent.⁵¹⁸

An example of *mudarabah sukuk* is the National Bonds Corporation and the Saudi Hollandi Bank. The National Bonds *mudarabah* is an open-ended investment fund, developed by the National Bonds Corporation. The bonds represent the funds that have been collected from the bond holders. These funds are held, managed and invested by the National Bonds Corporation as *mudarib*, in compliance with *Shariah* principles. A National Bond does not represent any specific interest of the holder in any division of the *mudarabah* assets. However, it does represent the holder's undivided share and entitlement to a part of the distributable profits in the *mudarabah* assets.

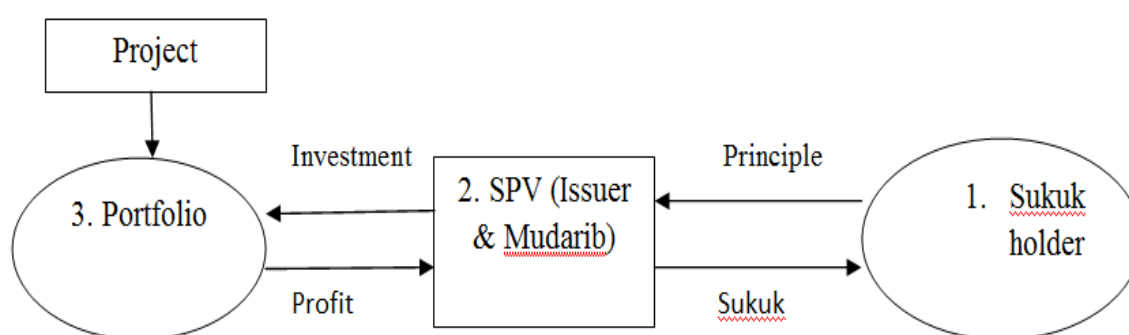
The National Bonds Corporation acts as an investment manager and manages the *mudarabah* assets for the investors or bond holders. The bond holders do not have the right to take part in the supervision of the *mudarabah* assets. The profits that are to be distributed are divided in the ratio of 80:20; and on the basis of a feasibility study, 60% of the *mudarabah* assets are to be invested in the pre-decided new projects and 40% in other investments, according to the rules of *Shariah*.

Development projects and infrastructure constitute 60% of the *mudarabah* assets, while shares, portfolios and funds constitute the remaining 40%. The profits projected for the former part of the investments range from 15% to 25% per annum, while the latter part are from 4% to 6% per annum. The overall investment of the National Bonds *mudarabah* capital would be intended to achieve a 15% rate of return per annum. The distribution of profits in the 80:20 ratio between the National Bonds Corporation and the bond holders would result in a 3% rate of profit for the bond holders.⁵¹⁹

⁵¹⁸ Karmila Kamil, Marliana Abdullah, Shahida Shahimi and Abdul Ghafar Ismail, 'The subprime mortgages crisis and Islamic securitization' *International Journal of Islamic and Middle Eastern Finance and Management* (2010) 3 (4) 393.

⁵¹⁹ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 63-65.

Figure 4.3 The Structure of *Mudarabah Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

4.5.4 Murabaha Sukuk

Murabaha sukuk is circulated in the market for the mobilisation of funds, so as to facilitate the trading of products (with certificate holders as owners). These are certificates with equal value, whose issuer is a supplier to the *murabaha* community. The key subscribers are the purchasers of the offered financial product. The funds gained from the subscribed contribution are recognised as its cost.⁵²⁰ The *sukuk* holders possess the right to the selling price of the *murabaha* commodity. A non-negotiable monetary debt receivable symbolises the *murabaha sukuk*, which has to be obtained from the client at the *murabaha* price. The below-mentioned steps indicate its structure:

The SPV and borrower enter into a contract on mutual agreement. *Sukuk* are issued by the SPV to investors on receiving the proceeds. The SPV purchases a *murabaha* commodity from the supplier on the basis of the options available on the spot. The SPV sells the commodity to the purchaser for the spot price and a profit margin, which can be paid in the form of instalments. Investors obtain profits by recovering the selling price.⁵²¹

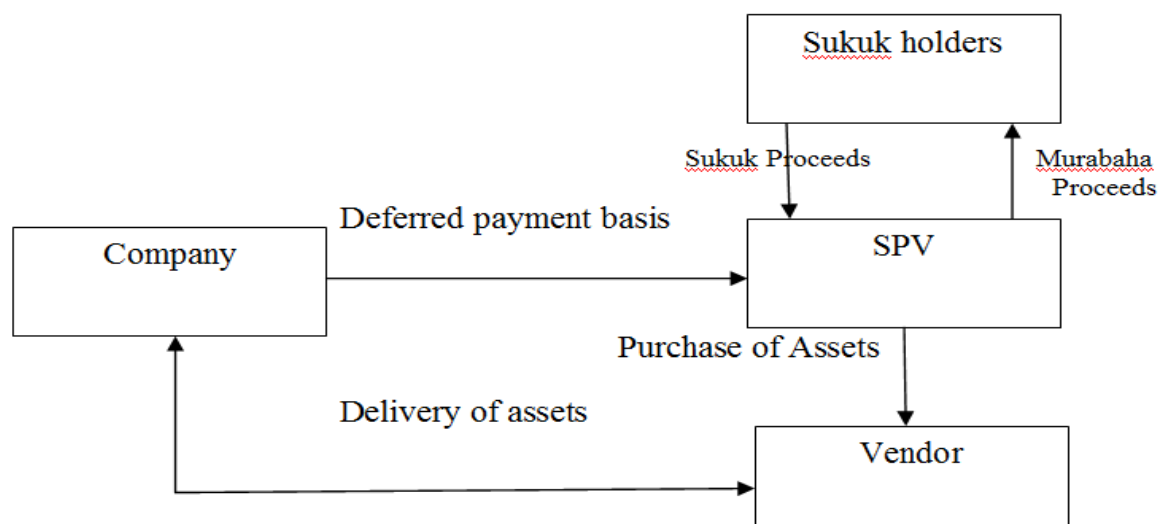
An example of *murabaha sukuk* is the Arcapita Bank. It issued multicurrency *sukuk* known as FIRSAN by following the *murabaha* structure on the basis of instalments from 2003 to 2005

⁵²⁰ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5 (12) 474.

⁵²¹ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65.

of \$100 million (in 2003), \$75 million (in 2004), and \$801 million (in 2005). It held the *sukuk* for 5 years with an estimated price of 175 basis points and LIBOR (3 months).⁵²²

Figure 4.4 The Structure of *Murabaha Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

4.5.5 Salam Sukuk

Salam sukuk is circulated in the market for the mobilisation of funds, so as to deliver the goods (with certificate holders as owners). These are certificates with equal value, whose issuer is the supplier of goods (covered under *salam*). Key subscribers are purchasers of the offered goods. The funds gained from the subscribed contribution of goods are recognised as its cost (*salam* capital). The certificate holders possess the right to the selling price of the *salam* goods. Despite this, it is non-tradable and is recognised as a receivable. *Shariah* obligations of *salam* such as quality, quantity, place of asset deliverance are applicable to *salam sukuk*.⁵²³

Prior to maturity, the purchased goods are not sold off again. These transactions have a relative magnitude that is equal to exchange of debt, which makes them less appealing to investors. Therefore, they are purchased by an investor in the case where the estimated price

⁵²² Kalid Alsaed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 52; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65.

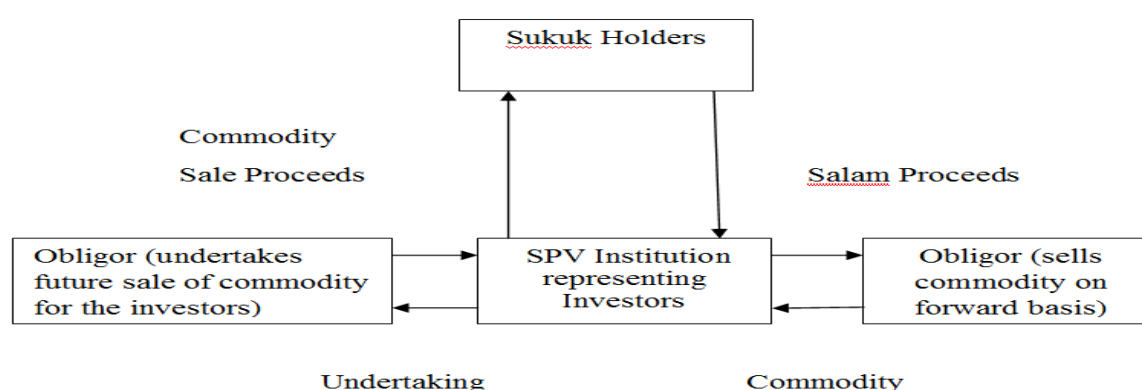
⁵²³ Rodney Wilson, 'Innovation in the structuring of Islamic sukuk securities' *Emerald Group Publishing Limited* (2008) 24 (5) 173; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65-66.

of a commodity is expected to reach a higher level by the time of maturity. In order to source the purchases and commodity, the SPV guarantees the agreement with an originator. On the part of the *sukuk* holders, the originator purchases the commodity and resells it in order to make a profit from the investment. The below-mentioned steps indicate the structure of *salam sukuk*:

SPV obtains the proceeds of the *sukuk* and provides them to the investors. The proceeds are handed over to the originator, who is responsible for selling the commodity by using a forward contract. The commodities are received by the SPV from the originator. The originator resells the commodities in order to make a profit. The sales proceeds from the commodity are received by the *sukuk* holders.⁵²⁴

An example of *salam sukuk* is the Bahrain Monetary Agency Salam Sukuk. Aluminium was specified to be a fundamental asset of the *salam sukuk* contract with the government of Bahrain.⁵²⁵ The Bahrain Islamic Bank (BIB) was assigned the responsibility of managing the contract with other banks and guaranteeing the deal as a syndicate authority. At the same time, the buyer appoints the Government of Bahrain as an agent to market the appropriate quantity at the time of delivery through its channels of distribution. In addition to this, the Government of Bahrain provides an additional undertaking to the representative BIB to market the aluminum at a price that will provide a return to *salam* security holders equivalent to those available through other conventional short-term money market instruments.⁵²⁶

Figure 4.5 The structure of *Salam Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

⁵²⁴ Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2010) 49; S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 65-66.

⁵²⁵ S.R. Vishwanath and Sabahuddin Azmi, 'An Overview of Islamic Sukuk Bonds', *The Journal of Structured Finance* [2009] 66.

⁵²⁶ Ibid.

4.5.6 Istisna Sukuk

Istisna sukuk is circulated in the market for the mobilisation of funds, so as to produce products (with certificate holders as owners). These are certificates with equal value, whose issuer is the supplier. The key subscribers are the purchasers of the offered financial product, and the funds gained from the subscribed contribution are recognised as its cost.⁵²⁷

The certificate holders possess the right to the selling price of the *Istisna* certificates. It is an important financial tool for managing the financing arrangements of large infrastructure projects. It facilitates financial intermediation on the basis of giving permission to the contractor for participation in another *Istisna* contract. Therefore, financial institutions can opt for guaranteeing a contract on a deferred price by subcontracting the authentic structure to a specified firm.⁵²⁸

The following steps are used for issuing *istisna sukuk*: For raising funds to meet the financial requirements of a project, *sukuk* certificates are issued by the SPV. Proceeds collected from the issuance of the *sukuk* are delivered to the contractor and used for future projects. The SPV takes the title to the assets. The project is rented or traded to the final purchaser, who pays monthly installations or make a deferred lump-sum payment when the project is completed to the SPV. Returns obtained from this issuance are disseminated within the group of *sukuk* holders.⁵²⁹

This example illustrates the structure of *istisna sukuk*. Under the guarantee of the National Central Cooling Company, in 2004 Tabreed offered global corporate *sukuk* of 5 years which were based on a fixed coupon rate of 5.5%. The offer included a combined arrangement of *ijarah Istisna* and *ijarah Mawasufah fi al Dhimmah* (forward leasing contracts). It was introduced in the market for the elimination of active debt of approximately US \$ 136 million and the expansion of financial arrangements.

⁵²⁷ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahiratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 473; Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2010) 51.

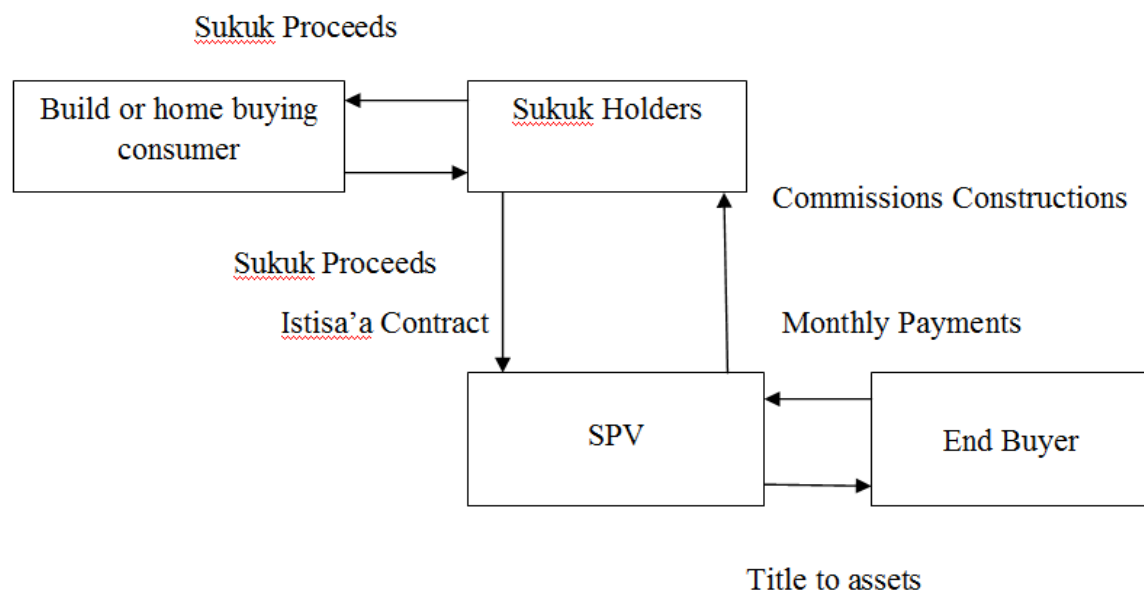
⁵²⁸ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 54; Mohamed Ariff, Munawar Iqbal and Shamsheer Mohamad, *Islamic Debt Market for Sukuk Securities: The Theory and Practice* (Edward Elgar Publishing 2012) 55-56.

⁵²⁹ Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 55.

The Durrat *sukuk* financed the reclamation and infrastructure for the initial stage of a broader US \$ 1 billion world class residential and leisure destination known as 'Durrat Al Bahrain', currently the Kingdom of Bahrain's largest residential development project. The return on the *sukuk* is 125 basis points over 3 months LIBOR payable quarterly, with the *sukuk* having an overall tenure of 5 years and an option for early redemption.

The proceeds collected were utilised for establishing the project on the basis of agreements considering *istisna*. On completion of the individual *istisna*, the contractor delivered it to the issuer, who was responsible for notifying the company undertaking the project (as per the *ijarah* agreement).⁵³⁰

Figure 4.6 The Structure of *Istisna Sukuk*



Source: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations (2012)

4.5.7 The Hybrid *Sukuk*

As an effective mode of investment and raising funds, the issue and trading of *sukuk* plays a vital role in fulfilling the diverse requirements of the investors. Therefore, the hybrid *sukuk* or mixed-assets *sukuk* have been introduced in the market. The inherent combination of assets considered in the hybrid *sukuk* can include receivables based on *murabaha*, *ijarah* and *istisna*

⁵³⁰ M. Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking*, Edward Elgar Publishing Limited, UK, 2007, p. 389; Kalid Alsaheed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 55-56.

financing options. Hybrid *sukuk* are comprised of a set of assets taken from different categories, which should include at least 51% of the tradable assets.⁵³¹

The structure of the *hybrid sukuk* involves the following steps. The assets and Murabaha deals should be transferred by the Islamic finance instigator to the SPV. The certificates of participation are issued by the SPV to the holders of the *sukuk* on receiving the funds, which are further utilised by the Islamic finance instigator. The pool of assets is purchased by the Islamic finance instigator for a specific period of time from the SPV. Returns from the invested assets are obtained by the investors in the form of fixed payments.⁵³²

The first hybrid *sukuk* were issued by the Islamic Development Bank (IDB) in 2009, and were comprised of a set of assets (Ijarah contracts 65.8%, Murabaha receivables 30.73%, and Istisna 3.4%). With the aim of obtaining assured rating and marketability in the international market, the issuance of hybrid *sukuk* necessitated a guarantee from IDB.

Solidarity Trust Services Limited (STSL) also issued hybrid *sukuk* of US \$ 400 million. In this issue, ICD (the Islamic Corporation for the Development of the Private Sector) remained engaged as an intermediary for buying the assets from IDB and trading them to STSL. The overall return on the investment was measured at the rate of 3.625 per annum for a fixed payment that was planned to be disseminated twice in a year and paid off by the month of August in 2008.⁵³³

4.6 The Regulatory Framework of Sukuk in Saudi Arabia

In Saudi Arabia, where the *sukuk* market is new and immature, the first issuance of *sukuk* was in 2004 on behalf of HANCO Rent-A-Car. The product was named the Caravan *sukuk*, and structured on an *ijarah* basis for three years.⁵³⁴ The researcher believes that this delay in the issuance of *sukuk* in Saudi Arabia was due to the lack of an independent body governing the

⁵³¹ Mohammad Nejatullah Siddiqi, 'Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art' *Islamic Economic Studies* (2006) 13 (2) 11; Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 474.

⁵³² Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 56-57.

⁵³³ Mohamad Zaid Mohd Zin, Ahamad Asmadi Sakat, Nurfahratul Azlina Ahmad, Mohd Roslan Mohd Nor, Azri Bhari, Saurdi Ishak and Mohd Sapawi Jamain, 'The Effectiveness of Sukuk in Islamic Finance Market' *Australian Journal of Basic and Applied Sciences* (2011) 5(12) 474; Kalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (Unpublished PhD Thesis, Durham University 2012) 57.

⁵³⁴ Abo Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010) 128.

issuance of securities. In 2003, the Saudi government established the Capital Market Authority (CMA) as a separate regulatory body under Article 4 of the CML in accordance with Royal Decree No. (M/30) dated 2 July 2003 to regulate and develop capital market activities in Saudi Arabia.⁵³⁵

Although there is no specific framework for the issuance of *sukuk* in Saudi Arabia, the CMA regulates and monitors the issuance of *sukuk* side-by-side with the issuance of shares and debt instruments under the CMA Listing Rules and the CMA Offer of Securities Regulations. The Listing Rules were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 3-11-2004 dated 4 October 2004 based on the Capital Market Law issued by Royal Decree No. M/30 dated 2 July 2003, amended by a Resolution of the Board of the Capital Market Authority Number 1-36-2012 dated 25 November 2012.⁵³⁶ The Offer of Securities Regulations were issued by the Board of the Capital Market Authority pursuant to its Resolution Number 2-11-2004 dated 4 October 2004 based on the Capital Market Law issued by Royal Decree No. M/30 dated 2 July 2003, amended by Resolution of the Board of the Capital Market Authority Number 1-28-2008 dated 18 August 2008.⁵³⁷ Therefore, the Listing Rules and the Offer of Securities Regulations are the regulatory measures that control the issuance of *sukuk* in Saudi Arabia.⁵³⁸

The researcher found that all Saudi securities laws and regulations, such as the CML, Listing Rules and the Offer of Securities Regulations did not mention *Shariah* or Islamic bonds (*sukuk*) in their articles even though Article 1 of the Basic Law of Governance in Saudi Arabia stipulates that the Constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.⁵³⁹ In this regard, Hasan says that despite 15 *sukuk* issuances from 2000 to 2008

⁵³⁵ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 190. See the official website of the Capital Market Authority (CMA),

<<http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/CH2Article4.aspx>> [Accessed 11 December 2013].

⁵³⁶ See the official website of the Capital Market Authority (CMA),

<<http://www.cma.org.sa/En/Documents/Listing%20rules.pdf>> [Accessed 13 December 2013].

⁵³⁷ See the official website of the Capital Market Authority (CMA),

<<http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx>> [Accessed 11 December 2013].

⁵³⁸ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵³⁹ See the official website of the Bureau of Experts at the Council of Ministers,

<<http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25>> [Accessed 12 October 2013].

and huge Islamic mutual funds in Saudi Arabia, there is no single piece of legislation specifically regulating the implementation of Islamic *sukuk* in Saudi Arabia.⁵⁴⁰

Therefore, there remain some regulatory difficulties between the CMA and the Ministry of Commerce and Industry concerning the issuance of *sukuk*. This is due to the fact that the Offers of Securities Regulations do not refer specifically to *sukuk*, and therefore they must be defined as debt instruments even though *Shariah*-compliant *sukuk* do not create a debt obligation on the issuer.⁵⁴¹

4.7 Critiques and Recommendations of Current Sukuk Issuance Practice in Saudi Arabia

After reviewing the present regulation and supervision of *sukuk*, it is clear that the issuance of *sukuk* in Saudi Arabia is suffering from heavy regulation and supervision drawbacks, which need to be identified in order to resolve the problems of regulation and insufficiency of supervision. The researcher believes that there are two major drawbacks regarding the issuance of *sukuk* in Saudi Arabia from both the regulatory and supervisory aspects. The researcher will provide appropriate recommendations and suggestions for overcoming these drawbacks.

One of the major drawbacks is the absence of a legislative and regulatory structure for *sukuk* issuance in Saudi Arabia. According to Al-Elsheikh & Tanega, the financial regulations in Saudi Arabia do not include specific rules for the issuance of *sukuk*.⁵⁴² They argue that most of the articles in the Offers of Securities Regulations and the Listing Rules mention financial instruments as securities in general or refer to debt instruments (bonds) or stocks in some cases.⁵⁴³ They conclude that the issuance of *sukuk* in Saudi Arabia is not being regulated, issued or operationalised from within a framework that takes account of the nature of *sukuk* as distinct from conventional debt instruments, which means that *sukuk* in Saudi Arabia are issued as debt instruments.⁵⁴⁴ This argument is supported by Hasan, where he says that there is no single legislation specifically regulating the implementation of *sukuk* issuance, even

⁵⁴⁰ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97.

⁵⁴¹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 193.

⁵⁴² Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵⁴³ Ibid.

⁵⁴⁴ Ibid.

though there were 15 *sukuk* issuances in 2000–2008 and huge Islamic mutual funds in Saudi Arabia.⁵⁴⁵

Although there are differences between *sukuk* and conventional bonds, the Offers of Securities Regulations and the Listing Rules do not provide a clear distinction between *sukuk* and stocks, nor between *sukuk* and conventional bonds, thus possibly generating confusion between *sukuk*, bonds and shares.⁵⁴⁶ Moreover, Al-Elsheikh & Tanega believe that the current regulations of securities issuance in Saudi Arabia do not provide an efficient mechanism for setting up and maintaining transaction-specific special purpose companies. This creates considerable obstacles, thereby hindering investors' ability to gain access to capital markets.⁵⁴⁷ Sheikh Taqi Usmani (chairman of the AAOIFI Shariah Board) has argued that most of the *sukuk*, especially those with a *musharaka* or *mudaraba* structure, are not lawful from a *Shariah* perspective because the assets in the *sukuk* may be shares of companies that do not confer true ownership but which merely offer *sukuk* holders a right to returns.⁵⁴⁸

The key solution to the absence of a legislative and regulatory structure for *sukuk* issuance in Saudi Arabia would be to extend the present regulations in order to cover a wider range of financial investment instruments, such as *sukuk*, through the issuance of a new regulations.⁵⁴⁹ The Board of the Capital Market Authority is the authority responsible for issuing such regulations, including in relation to Islamic bonds. When issuing new regulations concerning *sukuk* issuance, there are some essential points that must be considered by the Board of the Capital Market Authority:

The first is that any legislative and regulatory framework for *sukuk* issuance in Saudi Arabia must comply with the provisions and principles of *Shariah*. Article 1 of the Basic Law of Governance in Saudi Arabia endorses this where it stipulates that the constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.⁵⁵⁰ Therefore, any new

⁵⁴⁵ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97.

⁵⁴⁶ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵⁴⁷ Ibid.

⁵⁴⁸ Muhammad Taqi Usmani, 'Sukuk and their Contemporary Applications' <<http://www.kantakji.com/fiqh/Files/Markets/f213.pdf>>, 2011, [accessed 13 December 2013].

⁵⁴⁹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 195.

⁵⁵⁰ See the official website of Bureau of Experts at the Council of Ministers, <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25> [accessed 14 December 2013].

regulations of *sukuk* must take into account the principles of *Shariah* (the Holy *Quran* and the *Sunnah*) so that there is no conflict with the Basic Law of Governance in Saudi Arabia, which derives its authority from the provisions of *Shariah*.

The second point is that the new regulations of *sukuk* must be confirmed and approved by a *Shariah* Committee whose members are appointed by the proposed Saudi *Shariah* Advisory Council (SSAC) in order to ensure that the new regulations of *sukuk* comply with the principles of *Shariah*. The current financial regulations in Saudi Arabia which cover the issuance of shares and debt instruments do not consider *sukuk* because of the absence of a *Shariah* Committee or *Shariah* Adviser.⁵⁵¹ Currently, there is no independent central *Shariah* board to regulate and supervise Islamic banking activities and also to appoint a *Shariah* Committee like the *Shariah* Advisory Council (SAC) in Malaysia. However, a *Shariah* Committee or *Shariah* Adviser could be appointed by the CMA until the establishment of an independent body called the Saudi *Shariah* Advisory Council (SSAC).

The final point is that the CMA should adopt standards and guidelines that are published by international and regional institutions such as International Islamic Financial Market (IIFM), AAOIFI, and the Islamic Financial Services Board (IFSB) for the issuance of *sukuk*. For example, in 2008, the *Shariah* Board of AAOIFI has issued six recommendations on how *sukuk* should be structured, which dealt with matters of ownership, repurchasing and compliance. Although these standards are not binding, some countries such as Malaysia consider them. The Malaysian *Shariah* Advisory Board of the Securities Commission and Bank Negara Malaysia's *Shariah* Advisory Council (SAC) encompasses the opinions adhered to by the AAOIFI.⁵⁵² In addition, the CMA should consider resolutions and recommendations of the Council of Islamic Fiqh Academy (IFA), and the Council of Senior Scholars in Saudi Arabia regarding the issuance of *sukuk*.

Another major criticism is the absence of a central *Shariah* supervisory board. According to Al-Elsheikh & Tanega, the absence of such a board that specialises in Islamic finance is considered one of the major issues facing the Islamic financial sector in Saudi Arabia, as it

⁵⁵¹ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 195.

⁵⁵² Kabir Hassan and Mervyn Lewis & Michael Mahlke, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 325.

could lead to declining public trust in securities that are provided as Islamic products.⁵⁵³ These authors argue that although some IFIs have their own *Shariah* supervisory boards and follow the principles and guidelines that are published by international and regional institutions such as the IIFM, AAOIFI, and the IFSB, it is necessary to establish a central *Shariah* supervisory board to enforce its decisions and to create general guidelines and rules that should be taken into consideration by IFIs and the CMA in Saudi Arabia.⁵⁵⁴

This absence of a central *Shariah* supervisory board raises the probability of conflict in opinions (*fatwas*) between Islamic scholars about the issuance of *sukuk* in Saudi Arabia. These differing opinions between Islamic scholars may result in significant damage to the issuer of *sukuk* in addition to a loss of confidence among investors.⁵⁵⁵ An example of this conflict is the initial public offering of the Yanbu National Petrochemical Company (YANSAB) where the opinions of Islamic scholars are divided into two groups with different points of view. These differences of opinion arose because the company borrowed money from a conventional bank with an interest rate. The first opinion is represented by the opinion of Dr Yusuf Alshubaili, who stated that the main activities of the company were *Shariah* compliant and that contributing to YANSAB's initial public offering (IPO) was permitted even if the company was involved in non-*Shariah*-compliant activities such as borrowing small amounts of money from conventional banks. The other opinion is represented by Dr Yusuf Alahmad, who adopted the view that contributing to the IPO of the company was not permitted, due to the involvement of the company in a non-*Shariah*-compliant activity.⁵⁵⁶

The researcher recommends the establishment of a *Shariah* Advisory in the CMA called the Securities Commission Shariah Advisory Council (SCSAC) to regulate and supervise the issuance of *sukuk* in Saudi Arabia. The SCSAC is appointed by the CMA and the proposed Saudi *Shariah* Advisory Council (SSAC). For more details about how to establish an independent central *Shariah* board, and how to enact laws and regulations related to Islamic finance in Saudi Arabia, the researcher will provide a proposed legislative and regulatory framework for Islamic banking and finance in Saudi Arabia, including the issuance of *sukuk*.

⁵⁵³ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵⁵⁴ Ibid.

⁵⁵⁵ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁵⁵⁶ Ibid.

This will be covered at the end of Chapter Six (Derivatives in Islamic Finance and their Applications in Saudi Arabia).

Regarding the securities disputes, the Committee for the Resolution of Securities Disputes (CRSD) is the body responsible for looking into such disputes, under the Regulating Procedures for Resolution of Securities Disputes, issued by the Board of the Capital Market Authority under Resolution No. (1-4-2011) dated 23/01/2011.⁵⁵⁷ Although the issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA, the Regulating Procedures for Resolution of Securities Disputes do not mention anything about the resolution of *sukuk* issuance disputes.⁵⁵⁸

The researcher recommends currently amending the present Regulating Procedures for Resolution of Securities Disputes to cover disputes of *sukuk* issuance until specialised commercial courts can be established to look into commercial issues including the issuance of *sukuk*. These courts should take the opinion of the proposed SSAC in the Islamic banking and finance issues in order to avoid any conflict of opinion between them. The researcher will deal with this in more depth in Chapter Six.

Therefore, the issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA under the Offers of Securities Regulations and the Listing Rules without any legislative and regulatory frameworks of *sukuk* issuance, and also without standards and guidelines on the *Shariah* governance system. They are also issued without obtaining the approval of the *Shariah* board because there is no *Shariah* board in the CMA in Saudi Arabia.

In contrast, in Malaysia, the issuance of *sukuk* is regulated by the Securities Commission Malaysia under section 212 of the Capital Markets and Services Act 2007,⁵⁵⁹ and Guidelines on *Sukuk* are issued by the Securities Commission Malaysia (SC) under Section 377 of the Capital Markets and Services Act 2007 (CMSA).⁵⁶⁰ *Sukuk* issuance is regulated through the framework provided under the Islamic Securities Guidelines (*Sukuk* Guidelines). The structure of *sukuk* is based on the specific contract of exchange of *Shariah*-compliant assets, and it must be confirmed and approved by an independent *Shariah* Adviser who is appointed

⁵⁵⁷ See the official website of the Committee for the Resolution of Securities Disputes (CRSD), <<http://www.crsd.org.sa/En/Documents/RPRSD-En.pdf>> [Accessed 16 December 2013].

⁵⁵⁸ Ibid.

⁵⁵⁹ Capital Markets and Services Act 2007, Art. 212.

⁵⁶⁰ See the official website of Malaysia's Islamic finance marketplace, <<http://www.mifc.com/index.php?ch=39&pg=97&ac=247&bb=attachpdf>> [accessed 16 December 2013].

by the Securities Commission Malaysia or a *Shariah* Committee attached to a financial institution that operates Islamic banking activities approved by Bank Negara Malaysia.⁵⁶¹

4.8 Summary

This chapter has provided a comprehensive and critical review of *sukuk* issuance in Saudi Arabia, including its concept, mechanism, principles, practices and models as an Islamic alternative to conventional bonds. This chapter has also examined whether the current uses of *sukuk* provided by the CMA are compatible with the principles of *Shariah*. The research question of this chapter has discussed to what extent the issuance of *sukuk* in Saudi Arabia is consistent with *Shariah* requirements.

The issuance of *sukuk* in Saudi Arabia is regulated and supervised by the CMA side-by-side with the issuance of shares and debt instruments under the Offers of Securities Regulations and the Listing Rules. The researcher found that the issuance of *sukuk* in Saudi Arabia is not consistent with *Shariah* requirements. This is due to the lack of legislative and regulatory framework of *sukuk* issuance, and also there are no standards and guidelines on the *Shariah* governance system for institutions offering Islamic financial services. In addition, there is no independent central *Shariah* board to regulate and supervise the issuance of *sukuk* in Saudi Arabia, and also there are no specialised commercial courts to look into *sukuk* issues in Saudi Arabia.

The researcher recommended amending the present regulations for the offering and issuance of securities in Saudi Arabia in order to cover a wider range of financial investment instruments, such as *sukuk*. The researcher also recommended the establishment a *Shariah* Advisory Council in the CMA called the Securities Commission *Shariah* Advisory Council (SCSAC) to regulate and supervise the issuance of *sukuk* in Saudi Arabia. The SCSAC would be appointed by the proposed SSAC to ensure that the issuance of *sukuk* is in compliance with *Shariah* principles.

The researcher recommended adopting standards and guidelines that are published by international and regional institutions such as AAOIFI, IFSB and IIFM until the

⁵⁶¹ See the official website of Malaysia's Islamic finance marketplace, <http://www.mifc.com/index.php?ch=ch_kc_definitions&pg=pg_kcdf_overview&ac=229> [accessed 16 December 2013].

establishment of the proposed SSAC. The researcher also recommended amending the present Regulating Procedures for Resolution of Securities Disputes to cover disputes of *sukuk* issuance until specialised commercial courts are established to look into commercial issues including the issuance of *sukuk*. The researcher recommended transferring the Malaysian experience in the field of *sukuk* to Saudi Arabia with some modifications that are commensurate with the nature of the Saudi regime.

The next chapter will provide a critical analysis of the current Islamic insurance (*takaful*) applications in Saudi Arabia. The chapter will focus on the problems and challenges of *takaful* in Saudi Arabia from a legal point of view. The next chapter will also examine whether the law of supervision of cooperative insurance companies is compatible with the principles of *Shariah*. Finally, it will offer possible solutions to these problems.

CHAPTER FIVE: ISLAMIC INSURANCE (TAKAFUL) IN SAUDI ARABIA: PROBLEMS, CHALLENGES AND SOLUTIONS

5.1 Introduction

This chapter aims to give a comprehensive and critical review of *takaful* applications in Saudi Arabia, and the extent to which Saudi insurance law is consistent with *Shariah*. The chapter is divided into a number of sections. The first section provides an overview of *takaful*; the next section offers the basic principles of *takaful*. The third section covers the regulation and supervision of *takaful* insurance. Models of *takaful*, the differences between it and conventional insurance and the prohibition of conventional insurance are covered in section four. The next section examines *takaful* challenges in Saudi Arabia and provides solutions to meet those challenges. This section also gives a critical analysis of the law of supervision of cooperative insurance companies in Saudi Arabia, and their implementing regulations, and examines whether Saudi insurance law is consistent with Islamic *Shariah* as a constitution for the Kingdom of Saudi Arabia. Finally, a summary is provided.

5.2 Background of *Takaful*

The Islamic alternative to conventional insurance is Islamic insurance (*takaful*), which is based on the idea of shared responsibility, social solidarity, mutual cooperation or assistance, and brotherhood, and provides for mutual financial security and assistance to safeguard participants or members against a defined risk.⁵⁶² *Takaful* is considered to be an agreement or contract among participants (policyholders) to jointly indemnify the loss or damage that may be inflicted upon any of them, out of the fund to which they donate collectively. In other words, members contribute money into a pooling system in order to guarantee one another against loss or damage. So, if one of the policyholders has to be paid a claim, this is paid out of the combined pool of the policyholders' contributions.⁵⁶³ In a *takaful* contract, there are four parties involved: the participant, the operator, the insured and the beneficiary.⁵⁶⁴

⁵⁶² Wan Abdul Aziz, Azman Che Mat and Engku Wok Zin, 'A Study of Contributing Factors in Islamic Motor Insurance', *Sos*, (2011) 10 (1) 4; Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 405.

⁵⁶³ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

⁵⁶⁴ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 405.

The term *takaful* is mentioned in Section 2 of the Malaysian Takaful Act 1984⁵⁶⁵ as “a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose”,⁵⁶⁶ while the Saudi system employs the term ‘cooperative insurance’ in Article 1 of the Law on the Supervision of Cooperative Insurance Companies.⁵⁶⁷ Article 1 stipulates that insurance in the Kingdom of Saudi Arabia shall be undertaken through registered insurance companies operating in a cooperative manner as provided in the Article establishing the National Company for Cooperative Insurance promulgated by Royal Decree M/5 dated 7/02/1985, and in accordance with the principles of Islamic *Shariah*.⁵⁶⁸

According to Manjoo, *takaful* is not a new concept for Islamic commercial law, which means that there were some similar practices in early Islamic Arabic society.⁵⁶⁹ He adds that *takaful* comes from the concept of *Aqilah*⁵⁷⁰ (pooling of resources), and *Al-Dayyah*⁵⁷¹ (substitute penalty) which prevailed in Arabia during the time of the Prophet Mohammed, and even before, whereby members of a tribe would participate in sharing the burden of paying any compensation that arose when one of its members committed an offence which demanded pecuniary compensation.⁵⁷² In other words, the *takaful* system in the past was intended to distribute concentrated risk from a single individual to the tribe or family.⁵⁷³

According to Taylor, the roots of *takaful* were derived from the first constitution in *Medinah* of 622, when tribes agreed on some kinds of insurance, such as social insurance, relying upon practices such as *al-diyah* and *al-aqila* (wergild or blood-money to rescue an accused in accidental killings), *fidyah* (ransom of prisoners of war) and cooperative schemes to aid the

⁵⁶⁵ “This Act which came into force on 1st January 1985 was enacted to provide for the regulation of *takaful* business in Malaysia and for other purposes relating to or connected with *takaful*”. See *Takaful Act 1984*.

⁵⁶⁶ *Takaful Act 1984* (Laws of Malaysia) s 2.

⁵⁶⁷ Law on Supervision of Cooperative Insurance Companies 2003 (Saudi Arabian Monetary Agency) Article 1.

⁵⁶⁸ *Ibid*.

⁵⁶⁹ Faizal Manjoo, *Risk Management: A Takaful Perspective* (AL-Noor 2007) 10.

⁵⁷⁰ The *Aqila* is a clan committed, by an unwritten law of the Bedouins originating in the early stages of Islam, to pay blood money for each of its members. See *Islamic Insurance: A Modern Approach to Islamic Banking*, p. 57.

⁵⁷¹ *Al-Dayyah* is the substitute penalty. This is applicable in the event of an *al-Qisas* abrogation due to any of the manifold causes of expiation; absence of needed requirements; apprehension on the loss of the life of the person to be executed; and exceeding limits in inflicting penalties. See *Perspectives on Modern Criminal Policy & Islamic Sharia*, p. 165.

⁵⁷² *Ibid*.

⁵⁷³ Shafiel A. Karim, *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments* (Brown Walker Press 2010) 75-76.

needy, ill and poor.⁵⁷⁴ However, there are some different structures between the ancient practices of social insurance and the current *takaful* system. For example, the tribe or family was the legislator, and all members of the tribe or family paid against a defined risk without their choice, while the current system of *takaful* is organised by insurance companies under the principles of *Shariah*.

With respect to the legitimacy of Islamic insurance (*takaful*), there is no clear evidence from the Quran or Sunnah explicitly indicating the legality of *takaful* insurance. However, there are some connotations from the Quran, social and commercial practices of Prophet Mohammed, Qiyas (comparative arguments), and Ijma (the agreement of the whole Islamic world on an issue) which are considered the basis of the legitimacy of the Islamic insurance practices at the present time.⁵⁷⁵ For example, the Quran and Sunnah have stipulated the concept of mutual cooperation in many places. The Quran states to this effect:

“And co-operate ye with one another in righteousness and piety, and do not co-operate in sin and aggression”.⁵⁷⁶

The Prophet Muhammad said:

“The believers, in their affection, mercy and sympathy to each other, are like the body: if one of its organs suffer and complains, the entire body responds with insomnia and fever”.⁵⁷⁷

Some conferences have been held by contemporary Muslim jurists to discuss conventional insurance. Most of them believe that conventional insurance is prohibited by *Shariah* because it includes elements of usury (*riba*), uncertainty (*gharar*), and gambling (*maisir*). However, Muslim scholars have reached some resolutions about this issue through a series of such conferences, held since 1976,⁵⁷⁸ as below:

⁵⁷⁴ Syed Umar Farooq and others, ‘An Analytical Study of the Potential of Takaful Companies’, *European Journal of Economics, Finance and Administrative Sciences* [2010] 20, 56.

⁵⁷⁵ Nico P. Swartz & Pieter Coetzer, ‘Takaful: An Islamic insurance instrument’, *Journal of Development and Agricultural Economics* (2010) 2 (10) 335.

⁵⁷⁶ See verse 2 of Surah 5 of the Holy Quran.

⁵⁷⁷ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 2586* (Darussalaam for Publication and Distribution 1999) 1041.

⁵⁷⁸ Akhtarzaite binti Abdulaziz, ‘Al-Dharai and Maqasid al-Shariah: a case study of Islamic insurance’, *Intellectual Discourse*, (2010) 18 (2) 272.

- a. The First Conference on Islamic Economics, Mecca, 1976: Conventional insurance as practised today does not comply with the spirit of *Shariah* and does not fulfil the requirements which might render it permissible.⁵⁷⁹
- b. 10th Conference of Prominent Muslim Scholars, Saudi Arabia, 1977: Confirmed by consensus of opinion that conventional insurance in all its types is not permissible, whether it is life insurance or general insurance (on property).⁵⁸⁰
- c. The Islamic *Fiqh* Academy, Jeddah, 1985: Confirmed that conventional insurance is forbidden due to the uncertainties (*gharar*). In this conference, the Islamic *Fiqh* Academy issued three resolutions or decisions. The first resolution is that a commercial insurance policy with fixed-premium companies that deal in commercial insurance with an element of uncertainty (*gharar*) invalidates any contract. Therefore, all forms of commercial insurance, whether for self, for merchandise or otherwise are forbidden by *Shariah*. The second decision is that the Islamic alternative to conventional insurance is *takaful*, which is based on the idea of social solidarity, cooperation and donation, as well as re-insurance, which is considered permissible because it operates on the basis of cooperative insurance. The third one is that the Islamic *Fiqh* Academy calls on Islamic countries to establish mutual cooperative institutions for insurance and reinsurance as well.⁵⁸¹

Based on the above conferences and discussions, it is clear that conventional insurance is forbidden in *Shariah* because, as mentioned earlier, of the elements of usury (*riba*), uncertainty (*gharar*), and gambling (*maisir*). The Islamic alternative to conventional insurance is *takaful*, which is based on the idea of social solidarity (*Tabaru*), cooperation (*Taawun*) and joint indemnification of losses of the members.⁵⁸² Thus, *takaful* is permitted by the consensus or agreement of the Muslim community (*Ijma*), which is considered a secondary source of *Shariah*, because it is a contemporary issue, and not mentioned in the *Quran* and *Sunnah*.

⁵⁷⁹ Ibid.

⁵⁸⁰ Ibid.

⁵⁸¹ The International Islamic *Fiqhi* Academy. Conference 1 (1969) <<http://www.fiqhacademy.org.sa/qarat/2-9.htm>>, (accessed 30 April 2013).

⁵⁸² Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

According to Ayub, the main objective of the *takaful* system is mutual help rather than earning profit or any windfall gains, as in the case of conventional insurance,⁵⁸³ while Hassan thinks that the basic objective of *takaful* is to provide risk management protection for individuals and business enterprises in Islamically acceptable ways.⁵⁸⁴ Kabir's view is that the main purpose of *takaful* is to bring equity to all members of society, especially the poor and those with special needs,⁵⁸⁵ which means that profit earning is not the main purpose of *takaful* under *Shariah*, but rather the aim is to help others who face risks and share misfortunes. Therefore, the payment of a premium by policyholders is to assist those of them who need financial security and it is regarded as a donation contract.⁵⁸⁶ In contrast, Hussain and Pasha believe that the purpose of conventional insurance is to protect the risk-averse from suffering the full cost of those actions on the part of nature which affect them unfavourably.⁵⁸⁷ These essential points of *takaful* are applied in all its forms, such as general *takaful* or family *takaful* (an alternative to life insurance) where all members agree to help each other out with their contributions if any one of them faces any catastrophe or incurs any defined loss.⁵⁸⁸

The first *takaful* company was established in Sudan in 1979, under the name Islamic Insurance Co. Ltd. This company was able to distribute profits to its shareholders at the rate of 5% in 1979, 8% in 1980 and 10% in 1981. Following the success of this insurance company in Sudan, other Islamic insurance (*takaful*) companies were established in Islamic and in non-Islamic countries.⁵⁸⁹ Currently, there are over 60 companies offering *takaful* services in 24 countries around the world.⁵⁹⁰ For example, in Saudi Arabia, the first cooperative insurance company was established in 1980, also under the name of Islamic Insurance Co. Ltd, by the Faisal Islamic Bank (Sudan); after that, Malaysia started a *takaful*

⁵⁸³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 422.

⁵⁸⁴ Kabir Hassan and Mervyn Lewis & Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 193.

⁵⁸⁵ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 405; Kabir Hassan and Mervyn Lewis and Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011) 193.

⁵⁸⁶ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24; Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 405.

⁵⁸⁷ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 25.

⁵⁸⁸ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 422.

⁵⁸⁹ Mher Mushtaq Hussain and Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

⁵⁹⁰ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 428.

business in 1984, and then in Pakistan the first Islamic insurance company was established in 2004.⁵⁹¹

The takaful industry has been growing at a rate of 10–20% p.a., compared to the global average growth of the insurance industry which is 5% p.a.⁵⁹² In Saudi Arabia, according to the Saudi Arabian Monetary Agency (SAMA), in 2011 Gross Written Premiums (GWP) in the Saudi insurance market reached SR 18.504 billion, up from SR 16.387 billion in 2010. This represents an increase of 12.9%, compared to a 12% growth rate in 2010.⁵⁹³ Currently, Saudi Arabia's *takaful* insurance industry is considered the largest such industry in the world.⁵⁹⁴ Regarding the future of the *takaful* industry, Syed Umar Farooq estimates that the global *takaful* industry will grow by 20% and reach US\$ 10–15 billion within the next decade.⁵⁹⁵

Takaful services are available to meet the needs of all sectors of the economy, both at individual and corporate levels, to cater for the short- and long-term financial needs of various groups in society. *Takaful* business has also been developed in Saudi Arabia, Malaysia, Bahrain and UAE.⁵⁹⁶

5.3 The Basic Principles of *Takaful*

The general principles of *takaful* are the same as those of Islamic finance, which is, as mentioned earlier, the prohibition of usury (*riba*), uncertainty (*gharar*), and gambling (*maisir*), but *takaful* as a contract of mutual insurance is based on the principles of mutual cooperation (*taawun*) and donation (*tabaru*), cooperative risk-sharing, mutual responsibility, mutual protection, and solidarity among groups of participants. These principles may be combined in each *takaful* contract in different ways.⁵⁹⁷

⁵⁹¹ Muhammad Ayub, *Understanding Islamic Finance*, (John Wiley & Sons Ltd 2007) 428; Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

⁵⁹² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 428.

⁵⁹³ See the official website of the Saudi Arabian Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/SUR_InsuaMarketSurvey2011_En_2011> [Accessed 18 May 2013].

⁵⁹⁴ Ibid.

⁵⁹⁵ Syed Umar Farooq and others, 'An Analytical Study of the Potential of Takaful Companies', *European Journal of Economics, Finance and Administrative Sciences* [2010] 20, 71.

⁵⁹⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 428.

⁵⁹⁷ Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 296.

5.3.1 Mutual Cooperation and Donation

The basic principles of *takaful* are based on mutual cooperation (*taawun*) and donation (*tabaru*), where the risk is shared collectively and voluntarily by participants. Under these principles, policyholders cooperate among themselves for their common good, where every policyholder contributes a certain proportion of the full amount of his/her subscription to help those that need assistance as *tabaru*. According to Redzuan, Rahman and Aidid, the majority opinion by many contemporary Islamic jurists and scholars is that, for an insurance system to be acceptable by *Shariah*, it must be based on the principles of mutual cooperation (*taawun*) and donation (*tabaru*).⁵⁹⁸ In other words, the contribution or premium made by the participant is put into two accounts. One of them is treated as being for charitable donations according to the principles of *tabaru*. The other is an investment account that follows the principles of *mudarabah* (profit and loss sharing).⁵⁹⁹

5.3.2 Cooperative Risk-Sharing

One of the main principles of *takaful* is cooperative risk-sharing. Under this principle, policyholders contribute to the money pool and receive help from that pool through the funds coming from other members when a risk becomes a reality. In the *takaful* system, the risk is a shared responsibility among the members of the fund, whereas in conventional insurance, the risk is transferred from one party to another.⁶⁰⁰

5.3.3 Mutual Responsibility

Takaful is based on mutual assistance among the members of the fund, where each member is responsible for alleviating the misfortunes of the other members. Each member of a *takaful* fund shares the risks of all the other members. Put another way, the risks are shared among all the members, and every member's risks become the mutual responsibility of all the other members.⁶⁰¹

⁵⁹⁸ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 281-282.

⁵⁹⁹ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 405-406.

⁶⁰⁰ Oliver Agha, 'Tabarru in Takaful: Helpful Innovation or Unnecessary Complication', *UCLA Journal of Islamic and Near Eastern Law*, (2010) 9 (101) 104; Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 297. 296-297.

⁶⁰¹ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 25; Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 297.

5.3.4 Mutual Protection

Another important principle of *takaful* is mutual protection among the participants. Each member participates in protecting all the other members against loss or damage. This principle was practised during the life of the Prophet Muhammad.⁶⁰²

5.3.5 Solidarity among Participants

Under this principle, people who choose to contribute to a *takaful* fund are sharing common interests (the desire to protect themselves and all the other members from harm deriving from loss or damages) and common responsibilities (losses are divided and liabilities spread according to the community pooling system), and therefore, no members derive an advantage at a cost to others.⁶⁰³

5.4 The Regulation and Supervision of *Takaful* Insurance

In the niche sector, it is exciting to see the growth and development of the insurance sector. As compared to the traditional market, the demand and supply for insurance protection in terms of consumption of insurance per person or the contribution of the industry to the GDP, is comparatively less than in the market of developed insurance. It predominantly focuses on the policyholder's interest protection and the conformity of the insurer in accordance with *Shariah*. The interest of the policy holder is secured mainly in terms of the contribution of the life insurance premium, need for protection of income and property in non-life insurance, and sharing of profits fairly in both classes of insurance.⁶⁰⁴

The market for insurance requires more measures of supervision for lasting and firmness of growth of *takaful* insurance. A number of governments understand the requirements and have introduced an Act for *takaful* insurance and the regulations associated with it (Bahrain, Saudi Arabia, Sudan, Malaysia, Qatar and Jordan). Lack of regulation was the reason for the meagre coverage of the operation of the activities of *takaful* insurance in many other countries, despite the imposition of the act of *takaful* insurance. The blame for the lack of regulation can be classified into two reasons. First, in many countries, *takaful* is still in its

⁶⁰² Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 297.

⁶⁰³ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 25.

⁶⁰⁴ Kwon, W. Jean, 'Islamic Principle and Takaful Insurance: Re-evaluation', *Journal of Insurance Regulation*, (2007) 26 (1) 73.

infancy and traditional insurance companies are its opponents. To administer *takaful* insurance, the regulators may need to widen the existing laws for insurance and regulations.⁶⁰⁵

Second, the ultimate legislature of Pakistan is *Shariah*;⁶⁰⁶ it is also the constitutional law of Saudi Arabia and Afghanistan and in most Islamic countries *Shariah* is also the supreme law.⁶⁰⁷ Since all matters of business are tied up with the law of Islam, there is less need for these countries to have a special set of laws and regulations governing insurance. In these countries, *takaful* insurance must be guided according to Islamic principles. In Islamic societies, *Shariah* can also be used to resolve the conflicts between Muslim businesses and the individual, a practice seen in selected countries populated with Muslims such as Malaysia, Singapore and Indonesia.⁶⁰⁸

The issue of maturity of the market and competitiveness arises in many countries where both the traditional and *takaful* insurer exist. The law of *Shariah* binds the *takaful* insurers mainly in the context of sharing of profit, areas of investment and designing of the product. In life insurance operations, these types of limitations are clearly visible. The domestic markets of many countries have turned to liberalisation and privatisation by their respective governments. For example, the local market of Saudi Arabia was privatised in the early 2000s, permitting 100 per cent foreign equity ownership of local insurance firms. Full foreign ownership of insurance and re-insurance companies was also allowed by Jordan. As a result, the Middle East insurance market has become more competitive and is likely to see the insolvency of incompetent companies.⁶⁰⁹

In Saudi Arabia, the SAMA is considered the primary regulator of the Saudi Arabian insurance market under the Law on Supervision of Cooperative Insurance Companies,

⁶⁰⁵ Ibid, pp. 73-74.

⁶⁰⁶ Article 227 of the Pakistani Constitution stipulates that “all existing laws shall be brought in conformity with the injunctions of Islam as laid down in the Holy Quran and Sunnah...and no law shall be made which is repugnant to such injunctions.” See to Constitutional Theocracy, By Ran Hirsch. P. 104.

⁶⁰⁷ Article 1 of the kingdom's Basic Law of Governance clearly stipulating that “The religion in Saudi Arabia is Islam and the constitution is the Book of God and the Sunna (traditions) of His Messenger”. See Basic Law of Governance 1992, Art. 1.

⁶⁰⁸ Asif Ahmed Qureshi, ‘Analyzing the shariah compliant issues currently faced by Islamic Insurance’, *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 282.; Kwon, W. Jean, ‘Islamic Principle and Takaful Insurance: Re-evaluation’, *Journal of Insurance Regulation*, (2007) 26 (1) 74.

⁶⁰⁹ Kwon, W. Jean, ‘Islamic Principle and Takaful Insurance: Re-evaluation’, *Journal of Insurance Regulation*, (2007) 26 (1) 74.

promulgated by Royal Decree (M/32) dated 31 July 2003.⁶¹⁰ SAMA also directs the cooperative insurance companies in distributing 10% of the net surplus of the insurance surplus to policyholders directly or in the form of a reduction in premiums for the following year. The remaining 90% of the net surplus is transferred to the shareholders. SAMA has also mandated all insurance companies (existing and new) to obtain a licence by March 2008 to underwrite their business or exit the market. Notably, to obtain a licence, a company must be established as a joint stock company, and invest at least 20% of policyholder funds in government bonds and 20% in bonds issued by Saudi-authorised banks.⁶¹¹

There are some other related issues in addition to the regulation and administration of *takaful*. The issues are capital and solvency regulation, market entry regulation, market conduct regulation, corporate governance and investment regulation.

5.4.1 Regulation for Market Entry

The market size differs from country to country. The difference in market size is replicated in terms of the presence of weak market entry and regulation of capital. Usually, countries having strong government support tend to have large *takaful* insurance firms. The firms in Saudi Arabia, Malaysia and UAE are larger, compared to those located in the less careful market.

Examination of the insurance Acts of Saudi Arabia, Jordan and Iran, as well as the Takaful Act 1984 of Malaysia, reveals that none of them are using a needs test to control access to the market. They use minimum market entry capital like others, which differs according to market conditions. Here the question arises as to whether the domestic market of the *takaful* is large enough for the insurers to generate high profits and cover their expenses related to operations, and generate profits for their policyholders too, and this has become an issue for the insurer. What the reasonable solution is? The reasonable solution to this problem would lead to growth in the size of *takaful* insurance firms through various methods such as mergers and acquisitions; in other countries it will also lead to the extension of the business to the *takaful* markets. The *takaful* insurers need more opportunities for generating more revenues and for expanding risk and investment portfolios, as regionalisation and internationalisation

⁶¹⁰ Saudi Arabian Monetary Agency, 'Insurance Supervision Department', The Saudi Insurance Market Report 2011, < <http://www.sama.gov.sa/sites/samaen/Insurance/Pages/FAQs.aspx> >, 2011, (accessed 27 May 2013).

⁶¹¹ A.M. Best Special Report: GCC Takaful Regulation Lags Market Growth, Creating Uneven Playing Field', *Regulatory Review*, 2013, pp. 6-7.

are difficult and complex. Unless and until the insurer's present and original ideas can maintain financial and operational soundness in addition, the privatisation and liberalisation of the domestic market will not be very significant.⁶¹²

5.4.2 Regulation of Capital and Solvency

There are two types of funds managed by *takaful* companies, one for the policy holder and the other for the shareholder. There may also be a requirement to divide the funds of the policy holder into special and individual accounts in the life insurance sector. The insurer will be barred from combining the revenue sources by the separation of the funds and accounts and will also be forbidden to use one fund or account to cover any deficit in other accounts.⁶¹³

The capital of the insurer plays a very important role in the *takaful* business. The capital is the money the insurer obtains at the beginning without any interest from the investors; the investors in return want a part of the insurer's operating profits. The capital is used as an interest-free line of credit by the insurer for the policy holder for the year in which it experiences underwriting losses. The capital is used as a guiding force against the instability of the insurance operations. *Takaful* insurers, like all other insurance companies, are sensitive to instability in pricing as well as the market, and the economic and political environment, all of which affect the underwriting performance of the insurer whether individually or in aggregate form.⁶¹⁴

5.4.3 Regulation of Investment

The compliance of the insurer with *Shariah* probably the most pressurising part, in the context of investment. The guidelines of *Shariah* state that *takaful* firms invest their funds in bonds issued by the government agencies, in time deposits and in shares or funds, including the shares of Islamic companies. The investor can invest in non-Islamic companies and government investment corporations, whichever goods and services are termed *halal*. The guidelines do not allow the investor to invest in any lines that are incompatible, such as alcohol manufacturing, production of pork, conventional financial services, manufacturing of

⁶¹² Kwon, W. Jean, 'Islamic Principle and Takaful Insurance: Re-evaluation', *Journal of Insurance Regulation*, (2007) 26 (1) 74.

⁶¹³ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 284.

⁶¹⁴ Kwon, W. Jean, 'Islamic Principle and Takaful Insurance: Re-evaluation', *Journal of Insurance Regulation*, (2007) 26 (1) 75-76.

weapons, the tobacco industry, and entertainment such as hotels, casinos and the music industry. The key factor that affects insurance companies is the investment performance. Conventional investments are broader in size than *takaful* investments. This clearly shows that there is a vast scope for the development of investment for insurers and for other financial institutions.⁶¹⁵

The Islamic investment market is witnessing several developments: *halal* investment is being supported by Malaysia and the country is popular for this; the bank Negara Malaysia, the central bank of the country, issues directions regularly via the Shariah Advisory Council of the Securities Commission on such types of investment. The *takaful* insurance firms and Muslim investors in the country and outside the country can invest in up to approximately 500 listed companies on the Kuala Lumpur stock exchange. This is the result of efforts made by the central bank and the *Shariah* advisory council. Other *Shariah* comprising investments have been identified by *takaful* insurance firms with the aid of the central bank. For example, policy holders associated with Takaful Malaysia have an option to invest their savings in individual holding accounts of Takaful Malaysia, the Islamic bank, for a period covering from one month to 60 months.⁶¹⁶

In *takaful* fund investment, conflict between the principal and the agency may be present. On one side, *takaful* operators are expected to exercise prudence in making investment decisions and not to subject their policyholders' funds to potentially high return and high risk situations. On the other side, the holder of the policy encourages a high return on investments. The same applies to the shareholders and insurance agents because their share of the profit is directly related to the performance of the insurer's investment. This matter was not given due importance by any of the regulators, other than the International Association of Insurance Supervisors and the Islamic Financial Services Board in the form of a joint issue report.⁶¹⁷

5.4.4 Conduct of Market and Corporate Governance

In *takaful* insurance, corporate governance and market conduct are the most effectively and efficiently regulated areas. The conduct of business and the decision making is done by the

⁶¹⁵ Kwon, W. Jean, 'Islamic Principle and Takaful Insurance: Re-evaluation', *Journal of Insurance Regulation*, (2007) 26 (1) 76.

⁶¹⁶ Ibid.

⁶¹⁷ Ibid, pp. 76-77.

takaful insurers in accordance with the law of *Shariah*. This is a matter of ethical guidelines and strict, even rigid, moral standards. In accordance with the law or by their own wish, the creation of the *Shariah* board may include one or more policyholder as a member. It is suggested that these members should give the right to the policyholder to check their business books and let them know how the sharing of profit can be done. Many *takaful* insurance companies still need to build up their self-regulatory practices for the improvement and development of operational soundness and solvency in terms of finance.⁶¹⁸

5.5 Why Conventional Insurance is Prohibited and Unacceptable in *Shariah*

It is important to understand that Islam is not against the concept of insurance itself but against the basis of the operation of conventional insurance methods, which does not comply with the spirit of *Shariah* and does not fulfil the requirements which might render it permissible.⁶¹⁹ For instance, in conventional insurance, the premium paid by the participant to the conventional insurance companies is owned by the companies in exchange for bearing all expected risks of the participant.⁶²⁰ According to Syed Ibn-Abdin, it is not in accordance with *Shariah* for a trader to pay the amount of premium to the insurance company so that he may be indemnified.⁶²¹ From the viewpoint of *Shariah*, the basic objection to conventional insurance is that it is effectively a gamble upon the incidence of the contingency insured against, because the interests of both parties are diametrically opposed, and neither party knows whether their respective rights and liabilities can be enforced until the occurrence of the insured events.⁶²²

Contemporary Muslim jurists have discussed conventional insurance in a series of discussions held since 1976. For example, the First Conference on Islamic Economy, Mecca, 1976, confirmed that conventional insurance as practised today does not comply with the spirit of *Shariah*. In Saudi Arabia, the 10th Conference of Prominent Muslim Scholars, 1977, confirmed that conventional insurance in all its types is not permissible, whether it is life insurance or general insurance (on property). The Islamic Fiqh Academy, Jeddah, 1985, issued a *fatwa* declaring that conventional insurance is prohibited due to the uncertainties

⁶¹⁸ Ibid, p. 79.

⁶¹⁹ Sheila Nu Htay, Mohamed Arif, Younes Soualhi, Hanna Rabittah Zaharin and Ibrahim Shauggee, *Accounting, Auditing and Governance for Takaful Operations* (John Wiley & Sons 2012) 15.

⁶²⁰ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 284-285.

⁶²¹ Ibid, p. 283.

⁶²² Ibid, pp. 283-284.

(*gharar*).⁶²³ In Malaysia, the Malaysian National Fatwa Committee issued a *fatwa* that conventional insurance is prohibited (*haram*) due to the presence of elements of excessive uncertainty (*gharar*), interest (*riba*), and gambling (*maisir*).⁶²⁴

Most contemporary Muslim jurists have decided that conventional insurance is not allowed in Islam mainly because it contains the above-mentioned elements, and the invalid transfer of risk from the insured to the insurer. In addition, it contains an element of temptation and the possibility of cheating, and is therefore incompatible with the natural and ethical methods of earning money.⁶²⁵

Based on the above, it could be said that the main reason for the prohibition of conventional insurance is that the conventional insurance contract contains objectionable elements such as *gharar*, *riba* and *maisir*. Therefore, it should be stressed that the prohibition does not apply to the goals and objectives of insurance but rather to the way the contract is formulated.⁶²⁶ The question that arises here is, how does conventional insurance involve the elements of *gharar*, *riba* and *maisir*?

In the legal terminology of jurists, *gharar* is the sale of a thing which is not present at hand or is not known or a sale involving a hazard in which one does not know whether it will come to be or not, such as the sale of a fish in water, or a bird in the air.⁶²⁷ According to Muhammad Ayub, *gharar* means uncertainty about the subject matter and the price and also the rights and liabilities of parties in commutative contracts.⁶²⁸ In other words, *gharar* involves the uncertainty of terms resulting in deception or a lack of clear conditions and terms.⁶²⁹ Therefore, there is no clarity about payment as promised, and also no clarity in the insurance

⁶²³ Akhtarzaite binti Abdulaziz, 'Al-Dharai and Maqasid al-Shariah: a case study of Islamic insurance', *Intellectual Discourse* (2010) 18 (2) 272; Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 280.

⁶²⁴ Sheila Nu Htay, Mohamed Arif, Younes Soualhi, Hanna Rabittah Zaharin and Ibrahim Shaugee, *Accounting, Auditing and Governance for Takaful Operations* (John Wiley & Sons 2012) 5.

⁶²⁵ Akhtarzaite binti Abdulaziz, 'Al-Dharai and Maqasid al-Shariah: a case study of Islamic insurance', *Intellectual Discourse* (2010) 18 (2) 272; Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 280.

⁶²⁶ Renat I. Bekkin, 'Islamic Insurance: National Features and Legal Regulation', *Arab Law Quarterly* [2007] 21, p. 21.

⁶²⁷ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd (2007) 58.

⁶²⁸ *Ibid*, p. 419.

⁶²⁹ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 281.

contract about how much should be paid at the time of payment.⁶³⁰ *Gharar* is found if the liability of any of the parties to a contract is uncertain or contingent; in other words, delivery of one of the exchange items is not in the control of any party or the payment from one side is uncertain.⁶³¹ In general, there should not be the sort of ambiguity that gives rise to speculation.⁶³²

Gharar is involved in conventional insurance as a policyholder enters into a business deal in which his liability and the right both remain contingent. He loses the amount given as premium if the event of insurance does not occur, as in the case of general insurance. The insurer (company) does not know how much he will owe to the insured. In many cases, an insured also does not know how much he will pay ultimately to the insurer. In life policies, a policyholder has generally to lose all the premiums that he has paid if he cancels his policy within the first two or three years of the contract.⁶³³ Wan Ahmad concludes that conventional insurance does carry excessive *gharar* because the subject matter exchanged in the contract is money, and money is a kind of buying and selling contract, thus exposing the contract to conditions or requirements of reasonableness.⁶³⁴ Hij Abd Jabbar believes that conventional insurance is prohibited because there is uncertainty in the subject matter; for example, in whether the compensation in case of loss will be made or not.⁶³⁵ According to Mher Hussain and Ahmad Pasha, *gharar* can exist in insurance in four forms: in the existence, in the results of the exchange, in the contract period and finally in the outcome.⁶³⁶

Conventional insurance involves *riba* both directly and indirectly in its investment activities: the direct involvement of *riba* is an excess on one side in the case of exchange between the amount of premiums and the sum insured,⁶³⁷ for example, if a claim is not made in non-life

⁶³⁰ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 283.

⁶³¹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd (2007) 58.

⁶³² Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions', *Company Lawyer* (2009) 30 (1) 3.

⁶³³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 419.

⁶³⁴ Wan Marhaini Wan Ahmad, 'Some Issues of Gharar (Uncertainty) in Insurance', *Jurnal Syariah* (2002) 10 (2) 76-77.

⁶³⁵ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions', *Company Lawyer* (2009) 30 (1) 3.

⁶³⁶ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research*, (2011) 1 (8) 26.

⁶³⁷ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 419.

policies, the insurance company keeps almost the whole amount.⁶³⁸ While investment in interest-based businesses by the insurer refers to the indirect involvement of the policyholder in *riba*-based transactions, such as putting insurance funds in *riba*/interest-bearing instruments such as bond and loans.⁶³⁹ In addition, the presence of *riba* in conventional insurance contracts is through lending and borrowing funds/investment at a fixed interest rate.⁶⁴⁰

Maisir literally means gambling.⁶⁴¹ According to Faizal Manjoo, *maisir* is defined as risking or betting on a thing of economic value in a game of chance with the hope of obtaining more.⁶⁴² Another definition, given by Muhammad Ayub, is that *maisir* means wishing for something valuable with ease and without paying an equivalent compensation (*iwad*) for it or without working for it, or without undertaking any liability against it, by way of a game of chance.⁶⁴³ In gambling, one party is always hoping for a gain at the cost of another person losing.⁶⁴⁴ According to Mubbsher Khan, *maisir* in insurance is when policyholders invest a small amount of premium with the hope of gaining a large profit, but sometimes due to losses they lose the premium they have invested and the claims may be higher than the contributions.⁶⁴⁵ In this case, the company would probably be in deficit. However, the policyholder would lose the money paid for the premium if the insured event does not occur. Here, gambling is playing its role.⁶⁴⁶ *Maisir* is completely banned by Islam; in the Holy Quran, Allah has clearly declared *maisir* unlawful and there is no relaxation on this.⁶⁴⁷ References from the Holy Quran in this regard are:

⁶³⁸ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management* (2011) 1 (8) 26.

⁶³⁹ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 26; Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007). 419.

⁶⁴⁰ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business*, (2011) 3 (5) 280.

⁶⁴¹ Nico P. Swartz & Pieter Coetzer, 'Takaful: An Islamic insurance instrument', *Journal of Development and Agricultural Economics* (2010) 2 (10) 334.

⁶⁴² Faizal Manjoo, *Risk Management: A Takaful Perspective* (AL-Noor 2007) 7.

⁶⁴³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 62.

⁶⁴⁴ Jacky Lim and others, *History, Progress and Future Challenge of Islamic Insurance (Takaful) In Malaysia*, (Oxford Business & Economics Conference Program, St. Hugh's College, Oxford University 2010) 6.

⁶⁴⁵ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 283.

⁶⁴⁶ Jacky Lim and others, *History, Progress and Future Challenge of Islamic Insurance (Takaful) In Malaysia*, (Oxford Business & Economics Conference Program, St. Hugh's College, Oxford University 2010) 6.

⁶⁴⁷ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 283.

“O you who have believed, indeed, intoxicants, gambling, sacrificing to stones and divination by arrows, are abominable actions of Satan; so abstain from them, that you may prosper”.⁶⁴⁸

“Satan intends to excite enmity and hatred among you with intoxicants and gambling, and hinder you from the remembrance of Allah, and from prayer; will ye not then abstain?”⁶⁴⁹

“They ask thee concerning wine and gambling. Say: ‘In them is great sin and some benefits for people; but the sin is greater than the benefits’”.⁶⁵⁰

According to Humayon Dar and Umar Moghu, the nature of insurance includes an element of *maisir* because the policyholders are held to be betting a premium on the condition that the insurer will make payment (indemnity) contingent upon the circumstance of a specified event. On the other hand, the insured does not receive anything back from their premium if the insured event does not happen at all.⁶⁵¹ For example, when the policyholder does not make any claim during the stipulated period, the insurance operator may obtain all the profit while the policyholder may not obtain any profit at all. The loss of premiums by the policyholder on abolition of contract will only be a burden to the policyholder. Furthermore, only a proportional refund will be made if any termination of contract is done by the insurance company.⁶⁵²

On the basis of the above discussion, it would seem that there are similarities between the conventional insurance contract and gambling. According to Abdul Wahab:

“There are similarities between *maisir* and the conventional insurance contract. The amount insured is paid back to the insurer when certain events occur. If the event never occurs, the insurance company keeps the premium. It’s like putting money in a pot and rolling the dice, the lucky winner takes the pot. In the case of conventional insurance companies, they play the role of the “House” and the insuree plays the role of the gambler by placing a bet. The gain for the “House” is always certain, while the

⁶⁴⁸ See verse 90 of Surah 5 of the Holy Quran.

⁶⁴⁹ See verse 91 of Surah 5 of the Holy Quran.

⁶⁵⁰ See verse 219 of Surah 4 of the Holy Quran.

⁶⁵¹ Humayon Dar & Umar Moghul, *The Chancellor Guide to the Legal and Shariah Aspects of Islamic Finance*, (Chancellor Publications Ltd 2009) 295.

⁶⁵² Abdul Rahim Abdul Wahab, Mervyn K. Lewis and M. Kabir Hassan and Mervyn Lewis, ‘Islamic Takaful: Business Models, Shariah Concerns, and Proposed Solutions’, *Thunderbird International Business Review* (2007) 49 (3) 374-375; Jacky Lim and others, , *History, Progress and Future Challenge of Islamic Insurance (Takaful) In Malaysia*, (Oxford Business & Economics Conference Program, St. Hugh’s College, Oxford University 2010) 7.

gain for the better is doubtful; the person may gain or lose. Overall, the “House” is against the gamblers, and the insurance company is against the insured, the “House” and the insurance company are always winners”.⁶⁵³

5.6 Differences between *Takaful* and Conventional Insurance

The difference between *takaful* and conventional insurance rests on the nature of the contract, and in the way the risk is assessed and handled, as well as how the *takaful* fund is managed. Further differences are also present in the relationship between the operator (in conventional insurance known as the 'insurer') and the participant (in conventional insurance this is the 'insured' or the 'assured').⁶⁵⁴

Regarding the nature of their contracts, while in conventional insurance the contract is based on the principles of exchange such as sale and purchase between the insurer and the insured, the *Takaful* contract is based on the principles of mutual cooperation and donation.⁶⁵⁵ On the basis of these principles, there is a difference in the contractual relationship between the policyholders, and also between the *takaful* operator and the policyholders. For example, in *takaful*, the relationship between the policyholders is that *takaful* members (policyholders) jointly own the funds in accordance with their contributions and undertake to mutually protect each other on the basis of gift.⁶⁵⁶ In conventional insurance, however, there is no relationship between the policyholders though they pay into the same insurance fund.⁶⁵⁷

Another example is about the relationship between the company or insurer in conventional insurance and the *takaful* operator in Islamic insurance, and the policyholders. In *takaful*, there are two types of relationships. Firstly, under the *takaful wakalah* model, the *takaful* operator acts as an agent on behalf of the participants to manage the *takaful* operations, and

⁶⁵³ Abdul Rahim Abdul Wahab, Mervyn K. Lewis and M. Kabir Hassan and Mervyn Lewis, 'Islamic Takaful: Business Models, Shariah Concerns, and Proposed Solutions', *Thunderbird International Business Review* (2007) 49 (3) 375; Humayon Dar & Umar Moghul, *The Chancellor Guide to the Legal and Shariah Aspects of Islamic Finance*, (Chancellor Publications Ltd 2009) 295.

⁶⁵⁴ Muhaimin Iqbal, *General Takaful Practice: Technical Approach to Eliminate Gharar (uncertainty), Maisir (gambling), and Riba (usury)* (Gema Insani 2005) 2.

⁶⁵⁵ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 25.

⁶⁵⁶ Akhtarzaite binti Abdulaziz, 'Al-Dharai and Maqasid al-Shariah: a case study of Islamic insurance', *Intellectual Discourse* (2010) 18 (2) 273.

⁶⁵⁷ Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 117.

receives a salary for this service,⁶⁵⁸ while in the *mudarabah* contract, the *takaful* operator may play the role of *mudrib* or entrepreneur.⁶⁵⁹ Under this model, the *takaful* operator and its policyholders share profits and losses based on the rate at which the *Shariah* committee agrees. The *takaful* operator is not responsible for any loss unless the loss stems from the company's own negligence or misconduct.⁶⁶⁰ In conventional insurance, however, according to Mubbsher, the relationship between insurer and insured is a seller–purchaser relationship or one-to-one relationship.⁶⁶¹

With regard to the legality of the investment from the point of view of *Shariah*, *takaful* funds must be invested in *Shariah*-compliant investment, while conventional insurance funds may be invested in both *Shariah* and non *Shariah*-compliant investment.⁶⁶² This is one of the fundamental differences between Islamic and conventional insurance. In this regard, according to Mher and Ahmad, the distinction between the conventional and *takaful* insurance is more visible with respect to investment of funds.⁶⁶³ While insurance companies invest their funds in interest-based avenues, *takaful* companies invest funds in interest-free avenues and undertake only *Shariah* compliant business, and the profits are distributed in accordance with pre-agreed profit-sharing ratios in the *takaful* contract.⁶⁶⁴

According to Mher and Ahmad, *takaful* companies face additional risks as compared to conventional insurance because conventional insurance companies invest large amounts in fixed income securities on their balance sheet in order to minimise the risks and the variability associated with the equity.⁶⁶⁵

Under a *takaful* contract, the policyholder has the right to know how their money is used and how the surrender value is calculated, and *takaful* policyholders must be certain that neither

⁶⁵⁸ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 283-284.

⁶⁵⁹ Ibid.

⁶⁶⁰ Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 116-117.

⁶⁶¹ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 284.

⁶⁶² Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 117.

⁶⁶³ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 26.

⁶⁶⁴ Ibid.

⁶⁶⁵ Ibid.

returns nor funds paid out in claim settlements originate from unlawful means such as investments in stocks of companies producing non-halal goods; while in conventional insurance the policyholder has no right to know about this.⁶⁶⁶ In addition, policyholders have the right to know how profits from different investments are divided among the participants under the *takaful* contract, while under the conventional system there is no hard and fast rule for profit distribution, it totally depends on company management.⁶⁶⁷

The legal position concerning termination of the insurance contract differs between Islamic and conventional insurance. In Islamic *takaful*, if the policyholder decides to terminate a policy in a manner that is not provided under the terms of the contract, premiums are refundable along with any corresponding surrender value, less administrative fees.⁶⁶⁸ The legal aspect of this issue is that Islam does not allow the forfeiture of the premium, wholly or partly, as the amount of premium is considered to be a loan by the insured to the insurer. Therefore, there is no forfeiture of contributions in a *takaful* contract, and these contributions are distributed among the participant in the form of surplus; while in a conventional insurance contract, there is a clause that the insurer can forfeit the premium amount that is paid by the policy holders under certain circumstances.⁶⁶⁹

In risk assessment and handling, under conventional insurance the insurance is a risk transfer mechanism whereby the risk is transferred from the insurance company (the insurer) to the policy holder (the insured) in consideration of the insurance premium paid by the insured; while in *takaful*, there is no transfer of risk from participants to the *takaful* operator. Risks are shared among participants under a mutual guarantee scheme or *takaful* scheme.⁶⁷⁰

According to the *wakalah* model, the *takaful* operator acts as a *wakeel* (agent) on behalf of participants to manage the *takaful* fund whereby the operator receives contributions, pays claims, and arranges re-*takaful* and all other necessary actions related to the *takaful*

⁶⁶⁶ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 26.

⁶⁶⁷ Ibid, p. 27.

⁶⁶⁸ Ibid.

⁶⁶⁹ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 285.

⁶⁷⁰ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 25.

business.⁶⁷¹ In this case, the *takaful* operator is considered an employee and receives a salary (*wakala* fee) for services.⁶⁷² So the *takaful* operator is not undertaking risk; the risk is however distributed among the participants who have agreed to jointly assume the risk.⁶⁷³ On the principles of *mudarabah/musharakah*, the *takaful* operator should share in the profit.⁶⁷⁴ In this case, the *takaful* operator invests the savings and investment contribution, the participant's account, and the profit is shared between the member and the *takaful* operator according to a pre-agreed ratio;⁶⁷⁵ while in conventional insurance, the agent in the policy is paid out of the paid-premiums of the policyholder.⁶⁷⁶

On the basis of *takaful* principles, it is clear that *takaful* differs from conventional insurance, because the nature of the principles of *takaful* is different from that of conventional insurance as well as all the operations in *takaful* being in line with the *Shariah* principles. For example, the operation of *takaful* is based on the principle of the *mudarabah* model, which is profit and loss sharing techniques, an alternative to interest (*riba*) in conventional insurance.⁶⁷⁷

5.7 Models of *Takaful*

Various models of *takaful* have been adopted in different Muslim countries. The three main operational models used in the *takaful* industry are the *mudarabah* model, *wakala* model and hybrid model.⁶⁷⁸

5.7.1 The *Mudarabah* Model

Mudarabah is an Islamic contract between two parties: the capital provider (the *takaful* participants) and the *takaful* company (the *takaful* operator and shareholders) where one party

⁶⁷¹ Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 117.

⁶⁷² Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 285.

⁶⁷³ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 27.

⁶⁷⁴ Faizal Manjoo, *Risk Management: A Takaful Perspective* (AL-Noor 2007) 8.

⁶⁷⁵ Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to Help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 118.

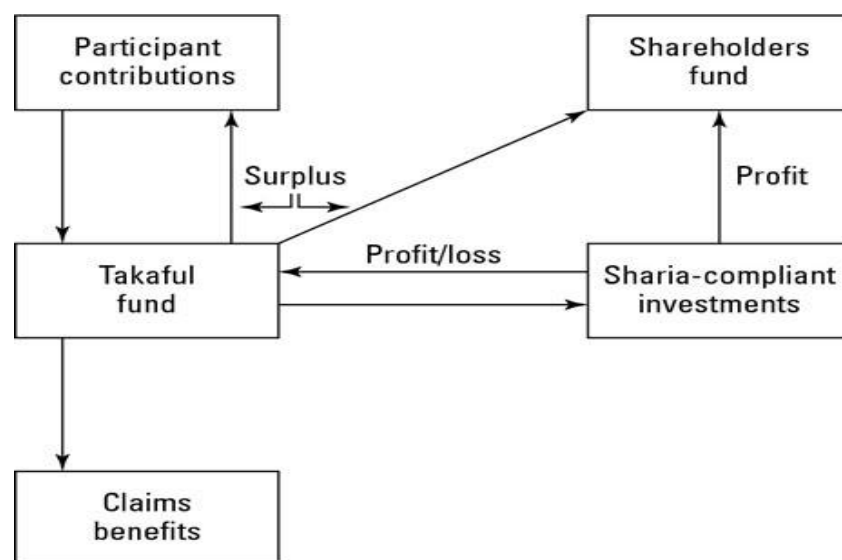
⁶⁷⁶ Faizal Manjoo, *Risk Management: A Takaful Perspective* (AL-Noor 2007) 8.

⁶⁷⁷ Syed Umar Farooq and others, 'An Analytical Study of the Potential of Takaful Companies', *European Journal of Economics, Finance and Administrative Sciences*, [2010] 20, 58.

⁶⁷⁸ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

contributes funds and another acts as entrepreneur.⁶⁷⁹ In *takaful* practice, the *takaful* operator manages the *takaful* operations in return for a share of the surplus on underwriting and a share of the profit from investment. Under this model, the profit is shared between the capital provider and the *takaful* operator according to the ratio agreed by both parties,⁶⁸⁰ while loss is borne entirely by the capital provider or the financier.⁶⁸¹ According to Ayub, in *mudarabah*, the financier bears the loss while the entrepreneur loses his already expended labour.⁶⁸² In the event of loss, the shareholder provides a loan (*qard hassan*) to meet the deficit. This *qard hassan* is repaid by the policyholders in times of profit.⁶⁸³ According to Mher and Ahmad, the sharing of profit and loss between the operator and participant based on the *mudarabah* model is determined in advance and judged on the basis of the company's developmental stage and earnings. The sharing ratio for each year is approved by the *Shariah* committee on an advance basis.⁶⁸⁴

Figure 5.1 How the *mudarabah* model works



Source: Islamic Finance For Dummies (2012).

⁶⁷⁹ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 308.

⁶⁸⁰ Mubbsher Munawar Khan, Hassan Mobeen Alam, Naveed Ahmad, Muhammad Sabeeh Iqbal and Salmat Ali, 'Comparative Analysis of Islamic and Prevailing Insurance Practices', *International Journal of Business and Social Science* (2011) 2 (10) 283.

⁶⁸¹ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 284.

⁶⁸² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 308.

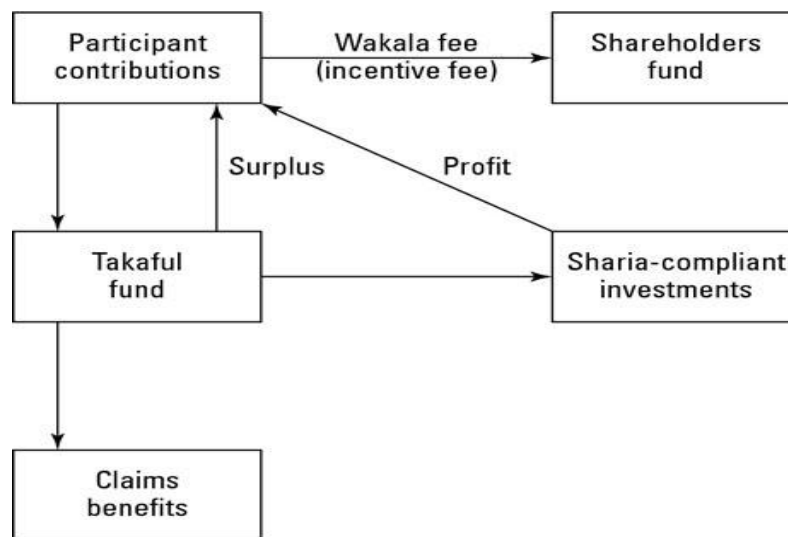
⁶⁸³ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3, (5) 284.

⁶⁸⁴ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

5.7.2 The Wakala Model

In Islam, *wakala* means a contract in which one entity works as an agent for another.⁶⁸⁵ In the case of a *wakala*-based *takaful* product, the *takaful* operator acts as an agent (*wakeel*) of the participants in managing the *takaful* fund in return for a defined fee.⁶⁸⁶ Under the *wakala model*, the surplus of the policyholders' funds and investments are distributed back to the participants only, based on the premise that the funds actually belong to the participants.⁶⁸⁷ According to Mher and Ahmad, the participants pay the *wakala* fee from contributions that cover the total operator expenses of the business and operator salaries. The *wakala* fee is determined by the *Shariah* Advisory Board of the company on a one-year advance basis. To provide an incentive to the operator for good governance, a management fee is paid as per the level of performance.⁶⁸⁸

Figure 5.2 How the *Wakala* model works



Source: Islamic Finance for Dummies (2012).

⁶⁸⁵ Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 315.

⁶⁸⁶ Asif Ahmed Qureshi, 'Analyzing the shariah compliant issues currently faced by Islamic Insurance', *Interdisciplinary Journal of Contemporary Research in Business* (2011) 3 (5) 284.

⁶⁸⁷ Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 113; Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 411.

⁶⁸⁸ Mher Mushtaq Hussain & Ahmad Tisman Pasha, 'Conceptual and Operational Differences between General Takaful and Conventional Insurance', *Australian Journal of Business and Management Research* (2011) 1 (8) 24.

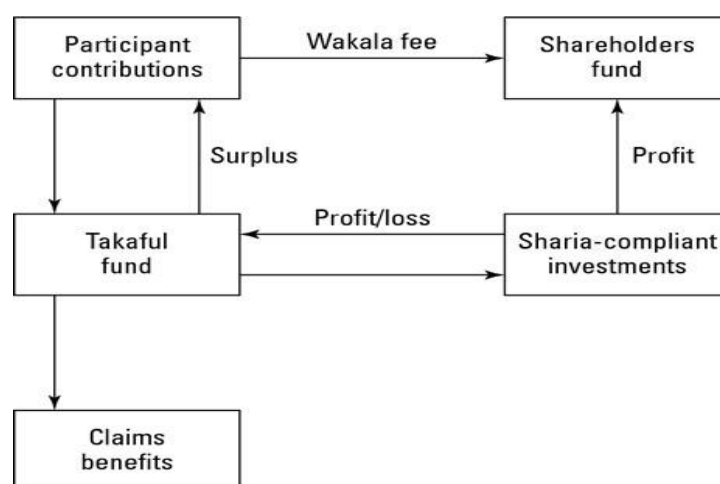
5.7.3 The Hybrid Model

This model combines elements of the *mudarabah* and *wakala* models, by utilising two funds. One fund is for the shareholders, and the other is for participants.⁶⁸⁹ In this model, the *mudarabah* contract is applied for investment activities where the *takaful* operator acts as the fund manager for managing investments and shares the profit for the investment of the *takaful* fund, while the *wakala* contract is used for underwriting activities where the *takaful* operator acts as the agent for the fund management and receives a fee for underwriting the fund.⁶⁹⁰

According to Julian Burling and Kevin Lazarus, the underwriting activities are performed using the *wakala* model, with the agent receiving a fee from each participant for the work performed. This fee is often a percentage of the contributions made by the participant.⁶⁹¹

This model has proven to be the most successful, having been adopted widely in the Middle East, and is recommended by the AAOIFI.⁶⁹²

Figure 5.3 How the *Hybrid* model works



Source: Islamic Finance For Dummies (2012).

⁶⁸⁹ Julian Burling & Kevin Lazarus, *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing 2011) 534.

⁶⁹⁰ Faleel Jamaldeen, *Islamic Finance For Dummies* (John Wiley & Sons Ltd 2012) 317; Brian B. Kettell, *The Islamic Banking and Finance Workbook: Step-by-Step Exercises to help you Master the Fundamentals of Islamic Banking and Finance* (John Wiley & Sons Ltd 2011) 113; Jacky Lim and others, *History, Progress and Future Challenge of Islamic Insurance (Takaful) In Malaysia*, (Oxford Business & Economics Conference Program, St. Hugh's College, Oxford University 2010)

⁶⁹¹ Julian Burling & Kevin Lazarus, *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing 2011) 534-535.

⁶⁹² Ibid.

In all three *takaful* models, the fund money must be invested in *Shariah*-compliant investment vehicles such as *sukuk* bonds, equities and property.⁶⁹³

5.8 Takaful Challenges and Solutions

In recent years, Saudi Arabia has become the leader in the Arab market in the field of *takaful* insurance and joint leader in the world with the Malaysian market. However, the *takaful* insurance industry in Saudi Arabia faces many obstacles and challenges which may represent an obstacle to the progress of this industry. These challenges are described as follows:

5.8.1 Incompatibility between the Law of Supervision of Cooperative Insurance Companies and its Implementing Regulations

The law of supervision of cooperative insurance companies was issued by Royal Decree No. M/32 on 01/08/2003, and its implementing regulations were issued by the Ministerial Decision No. 1/596 on 20/04/2004. Article 1 of this law and its implementing regulations stipulates that: “insurance companies [should] operat[e] in a cooperative manner in accordance with the principles of Islamic *Shariah*”⁶⁹⁴, but, in fact, there are multiple violations of the Decree in the implementing regulations themselves, resulting in cooperative insurance in Saudi Arabia being described as commercial and not cooperative. These violations are as follows:

The implementing regulations of the law controlling cooperative insurance companies did not explain the facts of cooperative insurance and controls, to avoid confusion and interference with commercial insurance. This problem made the judiciary in Saudi Arabia see that *takaful* insurance companies have the purpose and objectives of profitability, just as commercial insurance has. This made the insurance companies take legal measures to address this problem. One of these legal measures is increasing the conditions and controls that reduce the power of the judiciary. For example, when drafting the insurance policy, jurists benefit from the principle “complementary legal rules” which allows the parties to define the rights and obligations.

⁶⁹³ Julian Burling & Kevin Lazarus, *Research Handbook on International Insurance Law and Regulation* (Edward Elgar Publishing 2011) 535.

⁶⁹⁴ See the official website of the Saudi Arabian Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/4600_C_InsuraLaw_En_2005_08_17_V1.pdf> [Accessed 13 July 2013].

The other solution is to resort to arbitration as an alternative to the problems of the Saudi judiciary that apply to *Shariah*. Although the right to arbitration is stipulated in the *takaful* insurance policy documents, the means of arbitration are still not applicable in Saudi Arabia, and the reason for this is due to the weakness of the culture of arbitration in Saudi society. In addition, the beliefs of jurists and lawyers that the Saudi judiciary may marginalise arbitration and not recognise it makes resorting to arbitration a legal risk, and this may impose financial burdens on *takaful* insurance companies.

Article (70-2/e) stipulates that: “10% of the net surplus shall be distributed to the policyholders directly, or in the form of reduction in premiums for the next year. The remaining 90% of the net surplus shall be transferred to the shareholders’ income statement”.⁶⁹⁵ This is a commutative contract on surplus which makes the cooperative insurance commercial; even though it is intended to be a cooperative insurance, the surplus must be in favour of the insured where the surplus returns to them or is transferred to a special reserve account with insurance operations, or transferred for the next few years to reduce the premiums that will be taken from the insured.

Article (1) of the implementing regulations defines the function of insurance as “transfer [ring] the burden of risk from the insured to the insurer, and compensat[ing] those who are exposed to damage or loss by the insurer”. It also defines the contribution (premium) as the “amount offered by the insured to the insurer in exchange for the insurer’s acceptance to indemnify the insured for loss / damages resulting directly from a covered risk”. The insurance policy is defined by the same article as “a legal document/contract issued to the insured by the insurer setting out the terms of the contract to indemnify the insured for loss and damages covered by the policy against a premium paid by the insured”. The insurer is defined by Article (1) of the implementing regulations as “an insurance company that accepts insurance contracts directly from insured(s)”.⁶⁹⁶

All of these definitions confirm that the concept of cooperative insurance in Saudi Arabia is considered to be commercial insurance and not cooperative, because insurance companies in Saudi Arabia charge insurance premiums in exchange for their commitment to compensation. This makes the cooperative insurance commutative rather than cooperative, whereas the goal

⁶⁹⁵ See the official website of the Saudi Arabian Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/Insurance/InssuranceLib/IIR_4600_C_ReguExecutive_En_2005_08_18_V1.pdf> [Accessed 13 July 2013].

⁶⁹⁶ Ibid.

of cooperative insurance is solidarity and cooperation, managing *takaful* funds on behalf of the participants, and receiving a salary (*wakala* fee) for this service.

Article (61-1) of the implementing regulations stipulates that “if such investment policy was not approved by SAMA, the company shall adhere to the investment standards in Table (1), provided that investments outside the Kingdom shall not exceed 20% of the total investment and in accordance with Article (59-2)”.⁶⁹⁷ The problem here is that some of these investment receptacles or investment types contradict *Shariah* because they include interest (*riba*), which, as mentioned, is forbidden in Islam. Some of these investment receptacles are Saudi Government Bonds 20% minimum, Foreign Government Bonds (Zone A) 5% maximum, Bonds Issued by Domestic Companies 5% maximum, and Bonds Issued by Foreign Companies 5% maximum.⁶⁹⁸

Article (3-3) of the implementing regulations approved the practice of protection and savings insurance. This practice is regarded as life insurance, which is prohibited by the Council of Senior Scholars in the Kingdom of Saudi Arabia (considered the highest religious body in the Kingdom) because it includes lack of knowledge, uncertainty and unlawful taking of others' money.⁶⁹⁹ The Council of Senior Scholars believes that life insurance is a form of commercial insurance. *Fatwa* no. 14839 stipulates that: “life insurance is a form of commercial insurance, and it is prohibited because it includes lack of knowledge, uncertainty and unlawful taking of others' money”.⁷⁰⁰

Article (42) of the implementing regulations identifies re-insurance controls, and does not specify that this should be re-insurance with the cooperative insurance companies, but opens the way for re-insurance with all companies, including commercial insurance companies.

To address the above issues, I would recommend establishing an independent central *Shariah* board in Saudi Arabia, including a research centre specialising in the *takaful* insurance industry. This board of *Shariah* would benefit from some international institutions accredited in the field of Islamic economics and finance, such as the Accounting and Auditing

⁶⁹⁷ Ibid.

⁶⁹⁸ Ibid.

⁶⁹⁹ Portal of the General Presidency of Scholarly Research and Ifta, ‘Fatwas of the Permanent Committee, Group 1, Volume 15: Transactions 3, Working with Riba dealers’, <<http://www.alifta.net/Search/ResultDetails.aspx?language=en&lang=en&view=result&fatwaNum=&FatwaNumID=&ID=5454&searchScope=7&SearchScopeLevels1=&SearchScopeLevels2=&highlight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=108105102101032105110115117114097110099101#firstKeyWordFound>> [Accessed 15 July 2013].

⁷⁰⁰ Ibid.

Organization for Islamic Financial Institutions (AAOIFI), the Islamic International Foundation for Economics & Finance (IIFE), the Islamic Development Bank (IDB), the Council of Senior Scholars in the Kingdom of Saudi Arabia, and the Encyclopedia of Islamic Economics and Finance.

The researcher believes that it is of paramount importance to have an Islamic Insurance Act in Saudi Arabia as in Malaysia, and one which takes the multiplicity of Islamic schools into account. The researcher also believes that the law of supervision of cooperative insurance companies and its implementing regulations need to be amended by specialist members in *Shariah* and Islamic economics as well, in order to be compatible with the principles of *Shariah*.

5.8.2 Ineffectiveness of “Participants’ Body (PB)” in *Takaful* Companies

The nature of *takaful* companies is based on the existence of two separate accounts: the Participants’ Account (PA), legally known as the Participants’ Body (PB), and the Shareholders’ Account (SA), legally known as the Shareholders’ Body (SB).

In the contract of insurance, *takaful* insurance companies assume the management of insurance operations and investment funds on behalf of the participants in return for a specific share of the return on investment of these funds as a speculator (*mudarib*) or a fixed amount in advance as an agent (*wakeel*), or both, as in the hybrid model.

One of the challenges facing the *takaful* industry in Saudi Arabia is the absence of a real role of the Participants Body. It is known that the SB (shareholders / owners of the company) act in many financial and insurance interests on behalf of the participants and also the PB, while the real role of the participants’ entity is still absent. The reason is that the participants are the weaker party in the equation, and the analysis is that the interests of participants are under the tutelage and decisions of the SB, who are represented by the Board of Directors appointed by the shareholders, which works to protect the interests of shareholders in the first place.

For more clarification a number of questions are posed here, which should enable the reader to understand this challenge:

1. What will happen in the case of shareholders’ interests conflicting with the interests of participants?

2. Who determines the system used in the financial relationship in a *takaful* company, *wakala* or *mudarabah*?
3. Who determines the amount of the agency fee (*wakalah*) in the agency system in order to avoid any over-charging when determining the fee?
4. Who determines how to calculate the surplus? What is the basis of the distribution? When is it distributed? Will it be distributed in cash or go forward to the next year?
5. Who determines the position of previous rights of participants who did not renew their participation?

To address these issues, the researcher recommends:

Establishing a real legal entity known as the Participants' Body (PB), stipulated in the Memorandum of Association, and issuing a regulation for this entity approved by the Board of Directors;

Representation of participants on the Board of Directors of the company, having the right of correction, particularly in the adoption of various investment and insurance plans, and policies of calculating the insurance and distribution of the surplus to the participants, and setting conditions and controls for the representatives;

Holding a General Assembly for participants where they have the right of reservation on the performance of the Board of Directors, and demanding change in the event of proven incapacity or incompetence. In addition, attending the meeting of the General Assembly of the shareholders.

5.8.3 Challenges Facing the Shariah Supervisory Board (SSB)

The *Shariah* Supervisory Board (SSB) plays a significant role in the success of Islamic Financial Institutions (IFIs), especially in giving *Fatwa* (*Shariah* opinion) resolutions and Islamic rulings on the correctness of transactions and their validity according to the *Shariah* parameters and rules on financial transactions. In addition, the *Shariah* Board is also responsible for the duties of *Shariah* supervisory (SS) to ensure *Shariah* compliance in all the Islamic banks' operations and activities. However, this role still faces some obstacles that prevent its arrival at a high degree of effectiveness and impact, and these challenges include:

5.8.3.1 Ineffectiveness of some Shariah Boards (SBs)

The existence of the SSB in IFIs contributes to further assurance to the participants and shareholders to ensure compliance with Islamic *Shariah* principles in all *takaful* operations. However, the practice of some of the *takaful* insurance companies confirms that there is a weakness in the field audit and inspection by the SSB of the *takaful* operations, whereby it is possible that senior management or employees of *takaful* companies commit some violations of *Shariah* principles, all of which are either intentionally or unintentionally hidden from the eyes of the SSB, and sometimes this might be a motive for evasion of legal restrictions and controls that may be imposed by SSB on the *takaful* companies. These violations of *Shariah* principles are because the *Shariah* supervisory system is inadequate. For example, in some IFIs including *takaful* companies, the SSB convenes approximately twelve meetings annually, an average of one meeting each month. However, in the researcher's view, one meeting each month is not enough to ensure those *takaful* operations are complying with Islamic *Shariah* principles.

To address this challenge, the allocation of an internal and external *Shariah* audit committee in each *takaful* company, of no fewer than three members, should be appointed by the SSB to inspect, audit and review previous and subsequent *takaful* operations through daily reports sent to the SSB, in order to verify whether *takaful* companies operate within the constraints of *Shariah* law. This programme includes all operations, account shareholders and participants. In addition, the SSB should be allowed to attend the meetings of the Board of Directors and look at all its resolutions. The researcher recommends that the SSB must be independent, so as not to be subject to conflicts of interest.

5.8.3.2 Weakness of Technical and Vocational Rehabilitation for some Shariah Boards

Weak technical and vocational rehabilitation for some *Shariah* bodies reflects negatively on the ability to issue a *fatwa* in its true form. An example of weakness of rehabilitation is the inability of some *Shariah* bodies to inspect, audit and review the financial data of *takaful* operations.

The recommendation to meet this challenge is the establishment of a specialised scientific centre in the Islamic *takaful* insurance industry to work to support the legitimate and non-legitimate scientific aspects of this young industry, such that this centre can work on the establishment of a training centre specialising in the insurance industry, and can draw up

special training projects for the insurance industry. This centre could also offer specialised courses related to the rehabilitation of the members of the *Shariah* bodies in *takaful* companies and grant them specialist certifications.

The researcher recommends that a member of the *Fatwa* and SSB should hold a PhD in the field of Islamic finance and have experience in Islamic financial transactions to be able to understand contemporary issues and also to attempt to create new contracts to compete with conventional insurance and be compatible with *Shariah*. Members of the SSB should also know the English language in order to draft, inspect, audit and review contracts written in English.

5.8.3.3 The absence of Shariah Supervisory Systems

Some Islamic financial institutions are still not interested in finding a system of *Shariah* Supervisory Systems that defines the criteria that should exist for the various departments of financial institutions to follow and not exceed. The existence of clear standards in IFIs makes it easier for employees to adhere to them and also makes it easier for the SSB to follow up the implementation of those standards.

The researcher wishes to acknowledge here the role and the great effort of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in order to prepare the legal standards for Islamic financial institutions in general and *takaful* companies in particular.

5.8.3.4 Multiplicity of Shariah Boards and Judgements

According to Dr. Sahar Nasr, the most important challenge in the area of regulation and supervision is the multiplicity of *Shariah* boards and judgements because it impedes the homogeneity for some products on the one hand, and creates uncertainty for participants and shareholders about whether Islamic insurance products are *Shariah*-compliant on the other hand. While the cooperative insurance industry in Saudi Arabia is becoming increasingly internationalised, it remains a collection of segmented, weakly coordinated local operations. Therefore, there is a need for an effort to be made to resolve or at least mitigate the

uncertainty regarding the acceptance of *Shariah* rulings. This entails more cooperation on the part of *Shariah* Supervisory Boards (SSB).⁷⁰¹

The researcher recommends that the Saudi government should set up an independent central *Shariah* board instead of the SAMA, and give it all the necessary authorisation for overseeing all areas of the financial system including *Shariah* bodies in *takaful* companies, and for redrafting all articles of the Law on the Supervision of Cooperative Insurance Companies so as to render it compatible with the principles of *Shariah*.

Each member of the SSBs in Islamic financial institutions shall be selected by the central *Shariah* board instead of by Islamic financial institutions. The central *Shariah* board can gather with AAOIFI and Council of Senior Scholars (also known as the Senior Council of *Ulema*) to devise solutions to any *takaful* issues that may arise in the Saudi insurance sector.

5.9 Summary

This chapter has provided a background of the *takaful* industry, its inception, concept and mechanism, principles, practices and models as an alternative product to conventional insurance. The research question of this chapter has discussed how Saudi insurance law is consistent with *Shariah*. This chapter has analysed the principles and practices of *takaful*, the difference between *takaful* and conventional insurance, and the regulation and supervision of *takaful* insurance. The last section analysed the obstacles and challenges of *takaful* in Saudi Arabia, and their solutions.

The chapter has criticised the law of supervision of cooperative insurance companies in Saudi Arabia, and its implementing regulations, from the perspective of Islamic *Shariah* Law, and found that there are some articles that do not comply with Islamic *Shariah* Law, such as Articles (1), (70-2/e), (61-1), (59-2), (3-3), and (42) of the implementing regulations. The researcher believes that the law of supervision of cooperative insurance companies in Saudi Arabia and its implementing regulations needs to be amended by specialist members in *Shariah* and Islamic economics as well in order to be compatible with the principles of *Shariah*.

⁷⁰¹ Sahar Nasr, '*Islamic Finance in the Arab World: Challenges and Prospects*', Cambridge Business & Economics Conference (CBEC) (University of Cambridge 2011) 14.

The researcher recommended in this chapter establishing an independent central *Shariah* board in Saudi Arabia instead of SAMA, and give it all the necessary authorisation for overseeing all areas of the financial system including *Shariah* bodies in *takaful* companies, and for the redrafting of all articles of the Law on Supervision of Cooperative Insurance Companies so as to render it compatible with the principles of *Shariah*.

The next chapter will focus on derivatives in Islamic finance and their applications in Saudi Arabia. It will also conduct a comprehensive and critical review of Islamic derivatives as an alternative to conventional derivatives in Saudi Arabia, and examine whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*. A proposed legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia will be provided at the end of this next chapter.

CHAPTER SIX: DERIVATIVES IN ISLAMIC FINANCE AND THEIR APPLICATIONS IN SAUDI ARABIA

6.1 Introduction

The first financial derivatives emerged in Chicago in the early 1970s in response to increasing interest rates, exchange rates and volatile prices.⁷⁰² In the three decades before the credit crunch of 2008 and the global financial crisis, financial derivatives contracts grew rapidly to constitute a major component of the United States' financial system.⁷⁰³ However, despite their demonstrable importance for financial sector development, derivatives are few and far between in countries where capital market transactions are governed by *Shariah* law, such as Saudi Arabia.⁷⁰⁴

The aim of this chapter is to give a comprehensive and critical review of Islamic derivatives as an alternative to conventional derivatives in Saudi Arabia, and examine whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*. The chapter is divided into a number of sections. The first section will give background material on financial derivatives contracts and their legality from an Islamic point of view. The next section will offer a critical and comparative analysis of the principles and practices of financial derivatives. The third section will give a critical analysis of how Islamic financial derivatives work in Saudi Arabia. A proposed legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia will be covered in section four. The section after that will examine the legal challenges in applying the proposed framework for Islamic banking and finance in Saudi Arabia, and provide solutions to meet those challenges. A summary will be provided at the end.

6.2 Overview

According to the Bank for International Settlements (BIS), financial derivatives are financial contracts whose values/prices depend on the prices of underlying assets (often simply known

⁷⁰² Jayanth Verma, *Derivatives and Risk Management* (Tata McGraw-Hill Education 2008) 13.

⁷⁰³ Ibid.

⁷⁰⁴ Andreas A. Jobst & Juan Solé, 'Operative Principles of Islamic Derivatives – Towards a Coherent Theory', *International Monetary Fund* (WP/12/63, 2012) 3.

as the underlying).⁷⁰⁵ For example, the changing value of a crude oil futures contract depends primarily on the upward or downward movement of oil prices.⁷⁰⁶ These contracts are legally binding agreements, made on the trading screen of stock exchanges, to buy or sell an asset in the future. The underlying asset can be a share, index, interest rate, bond, rupee dollar exchange rate, crude oil, sugar, soybean, coffee, cotton or whatever else is being traded.⁷⁰⁷

Financial derivatives contracts are settled at a future date, and therefore no financial derivatives contracts are performed in the present market.⁷⁰⁸ Under paragraph 6 (b) of the Financial Accounting Standards Board (FASB) Statement No. 133: a derivative requires either no initial net investment or a smaller initial net investment than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.⁷⁰⁹ The values of financial derivatives (gains and losses) are dependent on the prices of the underlying assets.⁷¹⁰ Financial derivatives are financial agreements that are binding on both parties.

The basic purpose of derivatives is to create a mechanism to transfer risk from one party or firm that wants to avoid risk to another that is willing to absorb the risk. In this practice, one party's loss is always another party's gain.⁷¹¹ This practice is prohibited in *Shariah* because it involves speculative activities that can equate to gambling (*maisir*), and therefore run contrary to the principles of *Shariah*, as will be explained later.⁷¹² The Islamic alternative to

⁷⁰⁵ See the official website of the Bank for International Settlements (BIS), <<http://www.bis.org/publ/bcbs14.htm>> [Accessed 07 November 2013].

⁷⁰⁶ See Virginia B. Morris & Kenneth M. Morris, *Dictionary of Financial Terms* (Lightbulb Press Inc 2003) 55.

⁷⁰⁷ See the official website of the International Monetary Fund (IMF), <<http://www.imf.org/external/np/sta/fd/>> [Accessed 15 August 2013]; Bishnupriya Mishra & Sathya Swaroop Debasish, *Financial Derivatives* (Anurag Jain for Excel Books India 2007) 2.

⁷⁰⁸ R. Venkata Subramani, *Accounting for Investments, Fixed Income Securities and Interest Rate Derivatives: A Practitioner's Handbook* (John Wiley & Sons Ltd 2011) 269.

⁷⁰⁹ See the Official Website of the Financial Accounting Standards Board (FASB), <<http://www.fasb.org/derivatives/issuea1.shtml>> [Accessed 15 August 2013].

⁷¹⁰ R. Venkata Subramani, *Accounting for Investments, Fixed Income Securities and Interest Rate Derivatives: A Practitioner's Handbook* (John Wiley & Sons Ltd 2011) 269.

⁷¹¹ Robert Kolb & James A. Overdahl, *Financial Derivatives: Pricing and Risk Management* (John Wiley & Sons 2009) 58; Habib Ahmed, 'Financial crisis risks and lessons for Islamic finance', *ISRA International Journal of Islamic Finance* (2009) 1 (1) 10.

⁷¹² Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation* (2009) 24 (11) 557.

conventional derivatives is Islamic financial derivatives, which is based on a mechanism of equitable risk-sharing and underlying transactions in tangible assets.⁷¹³

6.3 Types of Financial Derivatives

According to Gupta, there are bewilderingly complex varieties of derivatives already in existence, and the markets are continuously innovating newer ones, and therefore it is difficult to classify financial derivatives, due to the complexity of their nature.⁷¹⁴ This chapter will focus on the most commonly used financial derivatives contracts: forwards, futures, options and swaps.

6.3.1 Forward Contracts

A forward contract is an agreement between two parties to buy or sell a specific amount of an asset to be delivered at a pre-agreed date in the future.⁷¹⁵ The purpose of a forward contract is to avoid price uncertainty and lock in a price for a future transaction.⁷¹⁶ In a forward contract, no initial payment is required. This kind of contract can be used for either hedging or speculation.⁷¹⁷

According to classical jurists of all the Islamic schools of jurisprudence, conventional forward contracts are forbidden in *Shariah*, based on a Prophetic tradition. They argue that although the price to be paid in the future is known, the future quality of the specified object of sale is unknown, which is a source of uncertainty and ignorance conducive to disputation. The second reason is that the practices of conventional forward contracts are essentially the exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.⁷¹⁸ In this practice, both the delivery of goods and payment are being made at a future date, which

⁷¹³ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation* (2009) 24 (11) 557.

⁷¹⁴ For example: plain, simple or straightforward, composite, joint or hybrid, synthetic, leveraged, mildly leveraged, customised or OTC traded, standardised or organised exchange traded. See S. L. Gupta, *Financial Derivatives: Theory, Concepts and Problems* (PHI Learning Pvt. Ltd 2006) 7.

⁷¹⁵ Marc Levinson, *Guide to Financial Markets* (5th edn, The Economist Newspaper Ltd 2010) 221.

⁷¹⁶ Sundaram Janakiraman, *Derivatives and Risk Management* (Dorling Kindersley (India) Pvt. Ltd 2011) 55.

⁷¹⁷ H R Machiraju, *International Financial Markets and India* (2nd edn, New Age International 2002) 99.

⁷¹⁸ Mahmoud A. El-Gamal, *Islamic Finance Law, Economics, and Practice* (Cambridge University Press 2006) 86; See the official website of The General Presidency of Scholarly Research and Ifta, <<http://www.alifta.net/Search/ResultDetails.aspx?language=en&lang=en&view=result&fatwaNum=&FatwaNumID=&ID=3613&searchScope=14&SearchScopeLevels1=&SearchScopeLevels2=&highlight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=10010109811603210211111403209711011116104101114032100101098116#firstKeywordFound>> [Accessed 19 August 2013].

means that this practice breaches the *Shariah* principle of ‘do not sell what you do not own’.⁷¹⁹

Therefore, the evidence for the prohibition of conventional forward contracts is based on a Prophetic tradition where the Prophet Muhammed forbade the sale of debt for debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.⁷²⁰ As a consequence of this *hadith*, conventional forward contracts are unlawful in *Shariah* as long as both the price payment and delivery of sale object are stipulated as future liabilities.

6.3.2 Futures Contracts

A futures contract is a standardised contract between two parties to buy or sell a fixed quantity of a commodity or an underlying financial instrument (such as a group of stocks) at a specified price during a particular delivery month.⁷²¹ For example, on 15 September 2013, dealers on the London Futures and Options Exchange would pay 250.49 pounds sterling for the delivery of two tons of corn at the end of December. While the futures contract specifies that an exchange will take place in the future, the purpose of the futures exchange is to minimise the risk of default by either party.⁷²²

Fundamentally, futures contracts are similar to forward contracts;⁷²³ however, according to Aswath Damodaran, there are three major differences between futures and forward contracts.⁷²⁴ First, futures contracts are traded on exchanges, whereas forward contracts are not. Consequently, futures contracts are much more liquid, and there is no default or credit risk. However, this advantage has to be offset against the fact that futures contracts are standardised and cannot be adapted to meet the firm’s precise needs. Second, futures contracts require both parties (buyer and seller) to settle differences on a daily basis rather than waiting for expiration of the contract. Thus, if a firm buys a futures contract for oil, and oil prices go down, the firm is obliged to pay the seller of the contract the difference. Because

⁷¹⁹ Asyraf Wajdi Dusuki & Abdelazeem Abozaid, ‘Fiqh Issues in Short Selling as Implemented in the Islamic Capital Market in Malaysia’, *JKAU: Islamic Econ* (2008) 21 (2) 63.

⁷²⁰ Muhammad ibn Abdullah al-Nishaburi, *Al-Mustadrak alaa al-Sahihain: Hadith number: 2389*, vol 2 (Dar al-Marefa 1998) 953.

⁷²¹ Bishnupriya Mishra & Sathya Swaroop Debasish, *Financial Derivatives* (Anurag Jain for Excel Books India 2007) 41.

⁷²² Bennett A. McDowell, *Survival Guide for Traders: How to Set Up and Organize Your Trading Business* (John Wiley & Sons 2011) 171.

⁷²³ Marc Levinson, *Guide to Financial Markets* (5th edn, The Economist Newspaper Ltd 2010) 221.

⁷²⁴ Aswath Damodaran, *Strategic Risk Taking: A Framework for Risk Management* (Pearson Prentice Hall 2008) 336.

futures contracts are settled at the end of each day, they are converted into a sequence of one-day forward contracts. This can have an effect on their pricing. Third, when a futures contract is bought or sold, the parties are required to put up a percentage of the price of the contract at a “margin”. This operates as a performance bond, ensuring there is no default risk.⁷²⁵

Item 5/1/2 of AAOIFI *Shariah* Standards No: 20 states that conventional futures contracts are not permitted either through their formation or their trading because they involve *gharar* (uncertainty) in the future delivery of the underlying asset.⁷²⁶ According to David Jonsson, any contractual speculation on future or conditional contracts is forbidden.⁷²⁷ Moreover, according to Resolution No. 63(1/7) of the International Islamic Fiqh Academy, conventional futures contracts are prohibited because they involve uncertainty and the exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.⁷²⁸

6.3.3 Options Contracts

An option is a contract to buy or sell an underlying asset at a specified price on or before a specified date.⁷²⁹ For example, if IBM is selling at \$120 and an investor has the option to buy a share at \$100 (the strike price), this option must be worth at least \$20, the difference between the price at which one can buy IBM (\$100) through the option contract and the price at which one could sell it in the open market (\$120). Such an option is said to be in-the-money. If the market price of IBM is equal to the strike price, then this option would be at-the-money. If the market price of IBM is below the strike price, the option would be out-of-the money.⁷³⁰

An option contract gives the buyer the right to sell or the right to buy.⁷³¹ Based on this principle, option contracts are classified into two broad categories: call option and put option. A call option gives the holder the right to buy an underlying asset by a certain date for a certain price. The seller is under an obligation to fulfil the contract and is paid a price of this

⁷²⁵ Ibid.

⁷²⁶ See Shari'a Standards for Islamic Financial Institutions 2010 (English Version), 367.

⁷²⁷ David J. Jonsson, *Islamic Economics and the Final Jihad: The Muslim Brotherhood to the Leftist/Marxist - Islamist Alliance* (Xulon Press 2006) 132.

⁷²⁸ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/qarat/7-1.htm>> [Accessed 04 February 2014].

⁷²⁹ M. Ranganatham & R. Madhumathi, *Investment Analysis and Portfolio Management* (Dorling Kindersley (India) Pvt. Ltd 2006) 180.

⁷³⁰ John R. Boatright, *Finance Ethics: Critical Issues in Theory and Practice* (John Wiley & Sons, UK, 2010) 229.

⁷³¹ M. Ranganatham & R. Madhumathi, *Derivatives and Risk Management* (Dorling Kindersley (India) Pvt. Ltd 2006) 134.

which is called “the call option premium” or “call option price”. A put option gives the holder the right to sell an underlying asset by a certain date for a certain price. The buyer is under an obligation to fulfil the contract and is paid a price for this, which is called “the put option premium” or “put option price”.⁷³²

The purpose of an option contract is to provide the offeree with time to evaluate the main contract offer.⁷³³ Options are used for hedging, risk management, speculation or investment.⁷³⁴ With regard to the legitimacy of option contracts in *Shariah*, option contracts are forbidden in *Shariah*. According to Resolution No. 63(1/7) of the International Islamic Fiqh Academy, option contracts are not permissible because they involve interest (*riba*), gambling and pure games of chance (*maysir*), uncertainty (*gharar*) and the exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.⁷³⁵

6.3.4 Swaps Contracts

Swaps are contractual arrangements between two parties who agree to exchange, over time and according to predetermined rules, streams of payment of the same amount of indebtedness.⁷³⁶ The basic idea behind swaps is that the parties involved obtain access to markets at better terms than would be available to each one of them individually.⁷³⁷ Swaps objectives are stated to include hedging of financial risks, reducing financing costs, conducting large-scale operations for more and more profit, access to new markets and, mostly, undertaking speculative activities to maximise gains.⁷³⁸

Under Section 901(f) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a swap agreement was amended to include numerous types of financial swaps

⁷³² Sudhindra Bhat, *Security Analysis & Portfolio Management* (Anurag Jain for Excel Books India 2009) 540.

⁷³³ Martin A. Frey & Phyllis Hurley Frey, *Essentials of Contract Law* (Delmar 2001) 73.

⁷³⁴ Jawwad Ahmed Farid & Fawzia Salahuddin, *Risk Frameworks and Applications* (2nd edn, Alchemy Technologies 2010) 52.

⁷³⁵ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/qararat/7-1.htm>> [Accessed 25 August 2013].

See too the official website of The General Presidency of Scholarly Research and Ifta, <<http://www.alifta.net/Search/ResultDetails.aspx?language=en&lang=en&view=result&fatwaNum=&FatwaNumID=&ID=3613&searchScope=14&SearchScopeLevels1=&SearchScopeLevels2=&highLight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=1001010981160321021111140320971101111161041011114032100101098116#firstKeyWordFound>> [Accessed 25 August 2013].

⁷³⁶ Paul Cullinane, ‘Incorporating derivatives data in the National Accounts and Balance of Payments’, *Economic & Labour Market Review* (2010) 4 (4) 44-45.

⁷³⁷ V. S. Somanath, *International Financial Management* (I. K. International Pvt Ltd 2011) 575.

⁷³⁸ See 8th International Conference on Islamic Economics and Finance: ‘Use of W’ad and Tawarruq for Swaps in the framework of Islamic Finance’, <<http://conference.qfis.edu.qa/app/media/317>> [Accessed 26 August 2013].

commonly used in conventional finance.⁷³⁹ According to Don Chance and Robert Brook, there are four primary types based on the nature of the underlying variable: interest rate swaps, equity swaps, commodity swaps, and currency swaps (also known as cross-currency interest swaps).⁷⁴⁰

According to *Shariah* principles, conventional swaps are prohibited because they clearly involve interest payments. An Islamic profit rate swap is the alternative to the conventional interest rate swap.⁷⁴¹

After a brief overview of conventional derivative contracts, and why conventional derivatives are unacceptable in Islamic finance, the chapter will move towards exploring financial structures available within an Islamic framework.

6.4 Islamic Alternatives to Conventional Derivatives

Islamic finance is based on *Shariah*, which provides guidelines for multiple aspects of Muslim life, including banking. As mentioned earlier, the basic principles of Islamic finance are the prohibition of interest (*riba*), excessive uncertainty (*gharar*), and speculation or gambling (*maysir or qimar*), and the adherence to profit and loss sharing between the parties to a transaction, as well as the promotion of ethical investments that enhance society and do not violate practices banned in *Shariah*. From these principles, it can be deduced that conventional derivatives contracts cannot be regarded as compliant with *Shariah*.⁷⁴² Therefore, it is important to look for Islamic alternatives to conventional derivatives.

⁷³⁹ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Section 901(f). Section 901(f) of the Act amends the definition of “swap agreement” to include an “interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap; a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement; a currency swap, option, future, or forward agreement; an equity index or equity swap, option, future, or forward agreement; a debt index or debt swap, option, future, or forward agreement; a total return, credit spread or credit swap, option, future, or forward agreement; a commodity index or commodity swap, option, future, or forward agreement; or a weather swap, weather derivative, or weather option.” See too: the United States Congressional Serial Set, Serial No. 14845, House Reports Nos. 40-50. See too: http://www.law.ttu.edu/lawlibrary/library/research/bapcpa_library/226-801-901.htm#901

⁷⁴⁰ Don Chance & Robert Brooks, *Introduction to Derivatives and Risk Management* (8th edn, Cengage Learning 2010) 407.

⁷⁴¹ Mohammed Obaidullah, ‘Financial Options in Islamic Contracts: Potential Tools for Risk Management’, *J.KAU: Islamic Econ* (1999) 11 (4) 18. See to 8th International Conference on Islamic Economics and Finance: Use of W’ad and Tawarruq for Swaps in the framework of Islamic Finance, <http://conference.qfis.edu.qa/app/media/317> [Accessed 26 August 2013].

⁷⁴² Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific 2010) 256.

A number of hedging tools exist in the Islamic financial industry that could be considered a basis for derivative contracts within the bounds of Islamic finance. These alternatives are *Bai Salam*, *Bai Urban*, *Khiyarat*, *Wad* and Islamic Swap (An Islamic Profit Rate Swap).⁷⁴³

6.4.1 Bai Salam as an Islamic Forward

According to AAOIFI, *bai salam* is the “purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment.”⁷⁴⁴ Therefore, *bai salam* can be seen as an Islamic forward wherein the price was paid in advance at the time of making the contract for prescribed goods to be delivered later.⁷⁴⁵ An Islamic forward is defined as a binding promise by the buyer, often an Islamic financial institution (IFI), to buy, and by the seller to sell a generic product of a specific quantity on a specific date in the future at an agreed-upon price.⁷⁴⁶ According to Anjum Siddiqui, the purpose of a *bai salam* contract is to “meet the capital requirements as well as cost of operations of farmers, industrialists, contractors or traders as well as craftsmen and small producers.”⁷⁴⁷ According to Mohammed Obaidullah, *bai salam* is a useful Islamic forward that can potentially be used for hedging.⁷⁴⁸

A *salam* contract is similar to a conventional forward contract. However, the main difference is that in an Islamic forward contract (*salam*), the buyer pays the entire amount for the product at the time of contract, while in a conventional forward, either full or partial payment is allowed to be made in advance.⁷⁴⁹

In *Shariah*, one of the basic conditions for the validity of a sale is that the commodity or underlying asset must currently exist in its physical sellable form or be in the constructive

⁷⁴³ Obiyathullah Ismath Bacha, ‘Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration’, *International Journal of Islamic Financial Services* (1999) 1 (1) 20; Obiyathulla Ismath Bacha & Abbas Mirakhor, *Islamic Capital Markets: A Comparative Approach* (John Wiley & Sons 2013) 315-316.

⁷⁴⁴ See the official website of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), <<http://www.aaofii.com/aaofii/IslamicFinancialDefinitions/tabid/209/language/en-US/Default.aspx>> [Accessed 06 September 2013].

⁷⁴⁵ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 241.

⁷⁴⁶ Abdul Rahim Al-Saati, ‘Sharia Compatible Futures’, *J.KAU: Islamic Econ* [2002] 15, p. 10.

⁷⁴⁷ Anjum Siddiqui, ‘Financial contracts: risk and performance of Islamic banking’, *Managerial Finance* (2008) 34 (10) 683.

⁷⁴⁸ Mohammed Obaidullah, *Islamic Financial Services*, Scientific Publishing Centre (Scientific Publishing Centre, King Abdulaziz University 2005) 179.

⁷⁴⁹ Obiyathullah Ismath Bacha, ‘Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration’, *International Journal of Islamic Financial Services* (1999) 1 (1) 20.

possession of the seller.⁷⁵⁰ However, classical jurists agreed that the *salam* contract constituted an exception to the general prohibition of the sale of non-existent properties, as well as to the prohibition of the sale of properties that are not in the seller's possession at the time of sale.⁷⁵¹ Therefore, *bai salam* is a permissible sale based on certain mandatory conditions, as mentioned in Chapter three. In this regard, the researcher recommends modern jurists to stipulate such conditions in *salam* contracts, to minimise the elements of *gharar* and eliminate elements of *riba* therein.⁷⁵²

Parallel *salam* is the replication of the *salam* transaction, where the buyer (IFI) often enters into two different contracts, one where the IFI acts as a seller and another in which it is a buyer.⁷⁵³ The key condition of *Shariah* is that the two contracts (*salam* and parallel *salam*) must be independent of each other.⁷⁵⁴ IFIs may use parallel *salam* if they do not want possession of the underlying commodity.⁷⁵⁵ According to Muhammad Ayub, the delivery date in the parallel *salam* contract can be the same as in the original *salam* contract, but not earlier than that, as this would mean the sale of commodities that one does not own.⁷⁵⁶

According to Ayub, Islamic financial institutions use parallel *salam* to mitigate the risk when the IFI enters a contract to purchase commodities, as it simultaneously enters a contract with a buyer for those commodities. While in conventional firms, the risk can be mitigated by using hedging techniques,⁷⁵⁷ for *salam* with parallel *salam*, the IFI may face legal risk if the commodities cannot be delivered at the specified time unless the customer under parallel *salam* agrees to modify the delivery date.⁷⁵⁸

⁷⁵⁰ Jaquir Iqbal, *Islamic Financial Management* (Global Vision Publishing House 2009) 113; Obiyathulla Ismath Bacha & Abbas Mirakhor, *Islamic Capital Markets: A Comparative Approach* (John Wiley & Sons 2013) 315.

⁷⁵¹ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, UK, 2006, p. 82.

⁷⁵² Mahmoud El-Gamal, *Islamic Finance Law, Economics, and Practice*, Cambridge University Press, New York, 2006, p. 82.

⁷⁵³ David Eisenberg, *Islamic Finance: Law and Practice* (Oxford University Press 2012) 217.

⁷⁵⁴ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 252.

⁷⁵⁵ Obiyathullah Ismath Bacha, 'Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration', *International Journal of Islamic Financial Services* (1999) 1 (1) 21.

⁷⁵⁶ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 252.

⁷⁵⁷ Ibid.

⁷⁵⁸ Simon Archer & Rifaat Abdel Karim, *Islamic Finance: the Regulatory Challenge* (John Wiley & Sons 2007) 127.

6.4.2 Bai Urban

A *bai urban* contract refers to a sale with an earnest money deposited by the buyer with the seller as a part payment of the price in advance. Under an *urban* contract, the buyer pays a sum of money against the purchase price to the seller to indicate his intention and ability to implement the contract.⁷⁵⁹ The contract of *bai urban* stipulates that if the buyer continues with the transaction within the stipulated time period, the deposit will become a part of the price that has already been negotiated. Otherwise, if the buyer defaults or decides not to proceed, the earnest money will be forfeited in favour of the seller.⁷⁶⁰ According to Sidney Yankson, this practice of *bai urban* is almost identical to the option in conventional western finance. The key difference is that in an option contract, the premium paid for the option is not deducted from the sale price if the option is exercised, while in a *bai urban* contract it is considered a part payment of the purchase price.⁷⁶¹ In addition, some contemporary Islamic jurists believe that *bai urban* is similar to the call option, which is likewise binding on the seller but not on the buyer.⁷⁶² *Hanbali* jurists had even contemplated that the option period should be fixed; otherwise the seller may have to wait indefinitely for the potential buyer to decide whether or not to exercise his right.⁷⁶³

There was an argument among Islamic scholars about the legality of *bai urban*, and they used three doctrines (*madhhab*) to argue against the *bai urban* contract. They declared that the *bai urban* contract is forbidden, based on a Prophetic tradition. The evidence for their argument is that the Prophet forbade the sale of *bai urban*.⁷⁶⁴ They argued that a *bai urban* contract involves uncertainty (*gharar*), risk-taking, and the taking of money without any consideration of whether the seller possesses what the buyer paid for if the buyer defaults or decides not to proceed.⁷⁶⁵

In contrast to the majority of scholars, the *Hanbali* school deemed that the practice of *bai urban* is acceptable. They relied on a Prophetic tradition⁷⁶⁶: The Messenger of God was

⁷⁵⁹ Sidney Yankson, 'Derivatives in Islamic Finance: A Case for Profit rate Swaps', *Journal of Islamic Economics, Banking and Finance* (2011) 7 (1) 46.

⁷⁶⁰ Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 91.

⁷⁶¹ Sidney Yankson, 'Derivatives in Islamic Finance: A Case for Profit rate Swaps', *Journal of Islamic Economics, Banking and Finance* (2011) 7 (1) 46.

⁷⁶² Mahmoud El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006) 91.

⁷⁶³ *Ibid.*, p. 91.

⁷⁶⁴ *Ibid.*, p. 92.

⁷⁶⁵ *Ibid.*, p. 91.

⁷⁶⁶ *Ibid.*, p. 92.

asked about *bai urban*, and permitted it.⁷⁶⁷ Classical *Hanbali* and contemporary jurists of most schools discussed the argument of the other schools. They argued that Prophetic traditions that provide support through the three schools was weak, and also that *bai urban* had become very common and provided some compensation to the seller for waiting, in case the buyer decided not to execute the sale.⁷⁶⁸

Under Resolution No: 72 (3/8) [1] of the OIC at its eighth session in Brunei in 1993, the Fiqh Academy of the Organization of Islamic Conferences endorsed the opinion of the *Hanbali* school. The OIC Fiqh Academy decided that *bai urban* is permitted if a time limit is specified for exercising the option.⁷⁶⁹ With regard to the deposit paid by the buyer to the seller in a buying and selling contract, the OIC Fiqh Academy decided that it is considered a part of the purchase price already negotiated if the sale proceeds. Otherwise, the earnest money will be forfeited as a gift (*hibah*) from the buyer to the seller if the buyer defaults or decides not to proceed.⁷⁷⁰

The researcher believes that the opinion of the *Hanbali* school is the closest to the truth owing to the power of their argument as well as because financial transactions nowadays need such a contract, which is considered one of the prominent Islamic hedging instruments. The researcher also believes that the prohibition of this type of hedging could put a large number of obstacles in the way of the Islamic finance industry, which is seeking to become a global industry.

6.4.3 Islamic Options (Khiyarat)

Islamic options (*Khiyarat*) are an Islamic alternative to conventional options that are prohibited, based on resolution No. 63(1/7) of the International Islamic Fiqh Academy.⁷⁷¹ *Al-khiyar* is a sale with an option to one or more of the parties to accept or annul a sale contract within a stipulated time period; for example, a defect in the goods.⁷⁷² The *Shariah* demands that the seller should disclose all the defects in the article being sold, otherwise the sale is not

⁷⁶⁷ Abu Dawud Sulayman ibn al-Ashath, *Sunan Abu Dawud*: Hadith number: 9964, vol 4 (Universal Dar for publication 2009) 155.

⁷⁶⁸ Mondher Bellalah, *Islamic Banking and Finance* (Cambridge Scholars Publishing 2013) 55.

⁷⁶⁹ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/qrarat/8-3.htm>> [10 September 2013].

⁷⁷⁰ Ibid.

⁷⁷¹ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/qrarat/7-1.htm>> [13 September 2013].

⁷⁷² Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies* (1998) 6,(1) 74.

valid. For example, if a person makes a purchase and is not aware, at the time of sale or previously, of a defect in the article bought, then the buyer has an option to annul the contract under *al-khiyar*, whether the defect is small or large.⁷⁷³

The purpose of *al-khiyar* is to protect the interests of both parties to the contract against cheating or misrepresenting the facts (*ghabn*) or risk (*gharar*). In *al-khiyar*, the possibility of conflicts between the parties to the contract can be reduced, to avoid any possibility of wrong committed against a party deliberately or unintentionally, through giving them a reassessment period, usually three days in Islam.⁷⁷⁴ Thus it can be said that *al-khiyar* achieves equality between the parties to the contract, and fulfilment of proper and reasonable expectations of the parties to the contract.⁷⁷⁵

The difference between *Khiyarat* and conventional options is essentially ethical. While conventional options in mainstream finance include all kinds of rights without obligations that have financial implications, *Khiyarat* offers the right for one or both parties to confirm or reject the contract.⁷⁷⁶

The permissibility of *Khiyarat* is inferred directly from the following *hadith* of the holy Prophet (peace be upon him) reported by al-Bukhari and Muslim. When Habban Ibn Munqidh complained to the holy Prophet (peace be upon him) that he was the victim of frequent fraud in some earlier transactions, the holy Prophet (peace be upon him) is reported to have said “Whenever you enter into contract, say to the other party that there shall be no fraud, and I reserve my right of *khiyar* in three days”.⁷⁷⁷ According to another *hadith* reported by al-Bukhari, the holy Prophet said, “the two contracting parties have a right of option as long as they are not separated or the sale was a sale of option”.⁷⁷⁸ This *hadith*, therefore, proves the basic validity of *khiyar al-shart* (option by stipulation) along with *khiyar al majlis* (option of the contracting session).⁷⁷⁹

⁷⁷³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 150.

⁷⁷⁴ Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre, King Abdulaziz University 2005) 184.

⁷⁷⁵ Adnan Siddiqi & Peter Hrubí, ‘Islamic Investments Funds Versus Hedge Funds’ (Unpublished Diploma Thesis, University of Vienna 2008) 124.

⁷⁷⁶ Ibid.

⁷⁷⁷ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1531*, International Ideas Home for Publication and Distribution 1998) 620.

⁷⁷⁸ Muhammad al-Bukhari, *Sahih Bukhari: Hadith number: 2107*, International Ideas Home for Publication and Distribution 1998) 397.

⁷⁷⁹ Mohammed Obaidullah, ‘Financial Engineering with Islamic Options’, *Islamic Economic Studies* (1998) 6 (1) 77.

According to classical jurists, the period of *al-khiyar* begins as soon as the agreement is formally concluded. There is an argument among jurists about the period of *al-khiyar*. According to *Hanbali* jurists, the right of option must be exercised within three days.⁷⁸⁰ They relied on a Prophetic tradition. The Prophet said: whoever buys a sheep unmilked (for a long time), has the right of option for three days.⁷⁸¹ According to the Hanafi and Shafii schools, however, the period of option is unlimited as long as it is known and defined at the time of contracting.⁷⁸² This opinion has become the prevailing one at the present time.

The jurists recognise several different types of *al-khiyar* including *khiyar al-shart* (option by stipulation); *khiyar altayeen* (option of determination or choice); *khiyar al majlis* (option of the contracting session); *khiyar al-ayb* (option for defect); and *khiyar al-ruyat* (option after inspection).⁷⁸³ The two main options for risk management are *khiyar al-shart* (option by stipulation) and *khiyar altayeen* (option of determination or choice).⁷⁸⁴ These types will be discussed briefly in the following subsections.

6.4.3.1 Khiyar Al-Shart (Option by Stipulation)

According to Munawar & Tariqullah, *khiyar al-shart* is an option in the form of a condition stipulated in a sale contract, about confirming or cancelling the sale contract within a specific time. This kind of *Al-khiyarat* (options) gives the right of option to one of the two parties to the contract, and even to a third party, to confirm or cancel the sale contract within a stipulated time.⁷⁸⁵ According to Mohammed Obaidullah, financial markets such as the stock market use *khiyar al-shart* as an Islamic hedging instrument for managing risk in the financial markets. For example, if party A wishes to enter into a purchase (sale) contract and stipulates a condition of option for itself for a period of two months, the delivery of price (stock X) can now be deferred until two months have expired. At the end of two months, if the price of stock X rises, then A can confirm the contract of purchase (sale) at the known contractual price and thus be immune from price risk. However, if the price of stock X falls, then A can rescind the contract and purchase in the market, thereby not losing the profit

⁷⁸⁰ Ibid.

⁷⁸¹ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1524*, International Ideas Home for Publication and Distribution 1998) 617.

⁷⁸² Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies* (1998) 6 (1) 77.

⁷⁸³ Ibid., p. 184.

⁷⁸⁴ Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds* (Unpublished Diploma Thesis, University of Vienna 2008) 125.

⁷⁸⁵ Munawar Iqbal & Tariqullah Khan, *Financial Engineering and Islamic Contracts* (Palgrave Macmillan 2005) 71.

potential. Thus, option by stipulation may provide a benefit for the party holding the option, at the cost of the counterparty. However, the disadvantage caused to the counterparty can be compensated by a higher contractual price and need not be paid separately up front to the counterparty. It is this feature that provides an effective curb on speculating on price differences and, thus, differentiates Islamic options from conventional ones.⁷⁸⁶

A question arises about the period of *khiyar al-shart*: there is an agreement among Sunni jurists that the period of *khiyar al-shart* is three days or less, but there is an argument that it is more than three days. Hanafi and Shafii jurists have held the view that there is no limit on the duration of the time period of *khiyar al-shart*, while *Hanbali* jurists have argued that the period of *khiyar al-shart* must not exceed three days, as stipulated in the Prophetic tradition. If the period of *khiyar al-shart* finishes without declaration from the option holder (either the seller or the buyer, or even a third party), the right of option will be invalidated, and therefore the contract will be binding on all.⁷⁸⁷

Munawar & Tariqullah discuss the argument between two different opinions of the scholars about the extent of the relationship between *khiyar al-shart* and conventional options. Some scholars have concluded that conventional options could be accommodated in *khiyar al-shart*, while other scholars have concluded that there are no grounds for legalising options by making an analogy with *khiyar al-shart*.⁷⁸⁸

6.4.3.2 Khiyar Al-Tayeen (Option of Determination or Choice)

According to Angelo Venardos, *khiyar al-tayeen* implies the option to choose an object of sale out of multiple varieties of a given article, which can be different in quality, design, material etc., and these varieties must not be more than three.⁷⁸⁹ For example, a buyer may wish to purchase one of three vehicles owned by the same seller, with the option to specify which one within a period of three days;⁷⁹⁰ whereas *khiyar al-shart* is a stipulation that any of the parties has the option to rescind the sale within a predefined period.⁷⁹¹ The similarity

⁷⁸⁶ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies* (1998) 6 (1) 92.

⁷⁸⁷ Ibid., p. 77.

⁷⁸⁸ Munawar Iqbal & Tariqullah Khan, *Financial Engineering and Islamic Contracts* (Palgrave Macmillan 2005) 71-72.

⁷⁸⁹ Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific 2010) 264.

⁷⁹⁰ Ibid.

⁷⁹¹ Ibid.

relates to stipulating the option in the contract and continuing for a specified time period.⁷⁹² Under this kind of Islamic option, the parties to the contract have more flexibility in their decision and, further, can compare whether the object or value to be exchanged matches their expectations.⁷⁹³ According to Younes and Mohd, however, in *khiyar al-tayeen* the buyer faces the challenge of a choice out of no more than three articles, and for optimal benefit he must choose the best of the three.⁷⁹⁴

There is significant disagreement among classical jurists about the legality of *khiyar al-tayeen*. According to the *Hanafi* school, *khiyar al-tayeen* is valid, based on *istihsan* (juristic preference) as it meets a legitimate need of the contracting parties. The *Shafii* and *Hanbali* jurists, on the contrary, consider that *khiyar al-tayeen* is invalid, in view of the state of ignorance (*jahalah*), and *jahalah* is considered *gharar*,⁷⁹⁵ which is forbidden in trading by the prophet Muhammed.⁷⁹⁶ Therefore, the contract of sale that contains *khiyar al-tayeen* is considered null and void because it includes uncertainty, according to the opinion of the *Shafii* and *Hanbali* jurists.⁷⁹⁷

The researcher supports the *Hanafi* opinion, because modern jurists permit some *gharar* transactions based on *maslahah* (public interest). In this regard, the researcher recommends that contemporary scholars, whether in Saudi Arabia or elsewhere, stipulate numerous conditions to contemporary financial transactions such as forward, futures, options and swaps to reduce *gharar*.⁷⁹⁸

According to Younes and Mohd, there are numerous challenges in Islamic options (*Khiyarat*). One of these is time of contract and time of delivery; as mentioned in the previous example in *khiyar al-shart*, the contract of sale can be cancelled, based on *khiyar al-shart*. Another challenge is the conditions of contract which are stipulated by the holder of the option. If these conditions have not been satisfied, then the contract can be cancelled.

⁷⁹² Adnan Siddiqi & Peter Hrubí, *Islamic Investments Funds Versus Hedge Funds* (Unpublished Diploma Thesis, University of Vienna 2008) 125.

⁷⁹³ Ibid.

⁷⁹⁴ Younes Elahi & Mohd Ismail Abd Aziz, 'Islamic options (al-Khiyarat); Challenges and opportunities' in *Proceedings of the 2011 International Conference on Information and Finance*, IPEDR vol.21 (IACSIT Press 2011) 101-104.

⁷⁹⁵ Mohammed Obaidullah, 'Financial Engineering with Islamic Options', *Islamic Economic Studies* (1998) 6 (1) 101.

⁷⁹⁶ Muslim ibn al-Hajjaj Nisaboori, *Sihih Muslim: Hadith number: 1513* (International Ideas Home for Publication and Distribution 1998) 614-615.

⁷⁹⁷ Abdul-Rahim Al-Saati, 'The Permissible Gharar (Risk) in Classical Islamic Jurisprudence', *J.KAU: Islamic Econ* (2003) 16 (2) 7.

⁷⁹⁸ Ibid., p. 15.

6.4.4 Wad (A Unilateral Promise)

According to Nouredine Krichene, promise (*waad*) refers to a unilateral promise by one party to complete a transaction (sale or purchase) at some specified date and in compliance with specified conditions.⁷⁹⁹ *Waad* has been used as a cornerstone for a variety of structured products and in the evolution of Islamic derivatives. For instance, *waad* can be used as a *Shariah*-compliant concept to replicate short-selling and hedging contracts such as profit-rate swap. *Waad* can also be used to structure a foreign exchange (forex) option.⁸⁰⁰

There are different opinions among Islamic scholars on the legality of this concept. Under Resolution No: 40 - 41 (2/5 and 3/5) [1], the OIC Fiqh Academy has ruled that *waad* is binding not only in the eyes of God but also in a court of law when it is made in commercial transactions; it is a unilateral promise; and it causes the promisee to incur liabilities.⁸⁰¹ The second view of AAOIFI is that a bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against the risk of currency devaluation, because binding bilateral promises from two parties are equivalent to a contract. In contrast, according to classical Fiqh rules, *waad* is not legally binding and the promising party may rescind his promise, therefore cannot be compelled by the process of law. The third view (of some Maliki jurists) is that *waad* is not binding in normal conditions, but if the promisor has caused the promisee to incur some expenses or undertake some labour or liability on the basis of a promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.⁸⁰² Shaikh Muhammad Taqi Usmani contends that the question whether or not a promise is enforceable in courts depends on the nature of the promise.⁸⁰³ But in commercial dealings, where a party has given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced.⁸⁰⁴

According to Hassan and Lewis, there are some conditions where *waad* is binding.⁸⁰⁵ These conditions are that the promise should be unilateral; it must have caused the promisee to incur

⁷⁹⁹ Nouredine Krichene, *Islamic Capital Markets: Theory and Practice* (John Wiley & Sons 2013) 637.

⁸⁰⁰ Ibid.

⁸⁰¹ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/qarat/5-2.htm>> [Accessed 19 September 2013].

⁸⁰² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 224.

⁸⁰³ Ibid.

⁸⁰⁴ Ibid.

⁸⁰⁵ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 88.

some costs/liabilities; if the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as a concluded sale; if the promisor reneges on their promise, the court may force them either to purchase the commodity or to pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by the promisee, and must not include the opportunity cost.⁸⁰⁶

6.4.5 Shariah-Compliant Swap Structures

There are a number of *Shariah*-compliant swap structures introduced by IFIs for the purposes of hedging such as foreign currency risk and interest rate fluctuations. The common types of these structures are the Islamic Cross Currency Swap (ICCS), and the Islamic Profit Rate Swap (IPRS).⁸⁰⁷ These types of Islamic swaps will be discussed below.

6.4.5.1 Islamic Cross Currency Swap (ICCS)

According to the Asian Finance Bank, the Islamic Cross Currency Swap (ICCS) is an agreement between two parties to exchange a series of profit and currency payments denominated in one currency for another series of profit and currency payments denominated in another currency, based on an actual principal amount over an agreed period. ICCS is used to protect assets against unfavourable benchmark rates and exchange rates by a series of profit payments in one currency by another currency, as well as providing fully *Shariah*-compliant instruments to customers to manage multi-currency swaps.⁸⁰⁸ In addition, they have other useful functions besides serving as a tool of risk management, such as reducing the cost of raising resources, better asset-liability management, and identifying appropriate investment opportunities.⁸⁰⁹

⁸⁰⁶ Ibid.

⁸⁰⁷ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation* (2009) 24 (11) 559-560.

⁸⁰⁸ See the official website of the Asian Finance Bank, [http://www.asianfinancebank.com/product_services/Treasury-PDS/PDS%20\(ICCS\).pdf](http://www.asianfinancebank.com/product_services/Treasury-PDS/PDS%20(ICCS).pdf) [Accessed 25 September 2013].

⁸⁰⁹ Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre, King Abdulaziz University 2005) 198-199.

Although these benefits also apply to conventional swaps, Islamic swaps are different in that they do not involve interest-related cash flows. Therefore, according to *Shariah* principles, conventional swaps are prohibited because they clearly involve interest payments.⁸¹⁰

According to one prominent view, Islamic swaps are not free from controversy and there is no consensus regarding their acceptability.⁸¹¹ Contemporary juristic opinion seems to reject Islamic swaps on different grounds. Obaidullah states that it is one of the principles of *Shariah* that two financial transactions cannot be tied together in the sense that entering into one transaction is made a precondition to entering into the second.⁸¹² Keeping this principle in view, the swap transaction is not permissible because, for instance, a loan of US \$50 is made a precondition for accepting a loan of Rs1100.⁸¹³

ICCS debuted recently when Standard Chartered executed the first ever swap transaction of this kind for Bank Muamalat Malaysia in July 2006.⁸¹⁴ The basic structures of ICCS used by the banks in Islamic swaps are two-commodity *murabaha* sale contracts that generate offsetting cash flows in opposite currencies with maturities desired by the contracting parties, *tawarruq* and *waad*.⁸¹⁵ An example of a two-commodity *murabaha* sale contract is where A makes a payment of Rs1000 to and receives US \$50 from B today at the given rate 1:20. Both A and B use and invest the money so received at their own risk. At the end of a stipulated time period, say six months, the transaction is reversed. A repays US \$50 to and receives Rs1000 from B. Simultaneously, Al Rajhi bank in Saudi Arabia buys an amount of commodity B, also under a *murabaha* agreement, but denominated in US dollars and sells it forward against payment in Malaysian Ringgit. By combining the two *murabaha* contracts, each denominated in a different currency, each party will be able to receive cash flows in the desired currency. Finally, both banks sell their respective commodities in order to recoup

⁸¹⁰ Mohammed Obaidullah, 'Financial Options in Islamic Contracts: Potential Tools for Risk Management', *J.KAU: Islamic Econ* (1999) 11 (4) 18. See too: 8th International Conference on Islamic Economics and Finance: 'Use of W'ad and Tawarruq for Swaps in the framework of Islamic Finance', <<http://conference.qfis.edu.qa/app/media/317>> [Accessed 26 August 2013].

⁸¹¹ Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre, King Abdulaziz University 2005) 198-199.

⁸¹² *Ibid.*, p. 199.

⁸¹³ *Ibid.*

⁸¹⁴ In October 2006, Citigroup designed a currency swap for the Dubai Investment Group (DIB) to hedge the currency risk on DIB's RM 828 million (approximately £119 million) investment in Bank Islam Malaysia. Standard Chartered Saadiq, Al Hilal Bank and Calyon also market products based on Shariah-compliant cross-currency swaps. See too *Islamic Derivatives: Theory and Practice, Global Islamic Finance Report 2010* (BMB Islamic UK Limited 2010) 137.

⁸¹⁵ Andreas Jobst & Juan Sole, 'The governance of derivatives in Islamic finance', *Journal of International Banking Law and Regulation* (2009) 24 (11) 559; Mondher Bellalah, *Islamic Banking and Finance* (Cambridge Scholars Publishing 2013) 58.

their initial expense, where the fair value of each commodity (A and B) should wash out at the prevailing exchange rate.⁸¹⁶

This form of contracting can also be viewed as an exchange of or swapping of interest-free loans between A and B. This is in contrast to conventional swaps, which are generally interest-based and involve the swapping of principal and interest payments. Conventional swaps clearly have no place in the Islamic system as they involve interest payments.⁸¹⁷

6.4.5.2 Islamic Profit Rate Swap (IPRS)

According to Bank Negara Malaysia (BNM), the Islamic Profit Rate Swap (IPRS)⁸¹⁸ is an agreement between two parties to mutually exchange profit rates between a fixed rate party and a floating rate party (or vice versa) through the execution of a series of *Shariah*-compliant sales contracts to trade certain assets. Therefore, IPRS is considered the *Shariah*-compliant version of the conventional Interest Rate Swap (IRS). The objective of IPRS is to enable the bank to manage the mismatch between cash inflow generated from the asset and cash outflow arising from payment of expenditure or cost of funding associated with the liability side of the balance sheet.⁸¹⁹

Under Resolution No. 85, IPRS was approved by the *Shariah* Advisory Council of Bank Negara Malaysia (SAC),⁸²⁰ in its 44th meeting dated 24 June 2004. The resolution stipulates that SAC “has resolved that the proposed offset practice in the IPRS structure is permissible and is not tantamount to the sale of debt with debt, which is prohibited by the *Shariah*”.⁸²¹

⁸¹⁶ Andreas Jobst & Juan Sole, ‘The governance of derivatives in Islamic finance’, *Journal of International Banking Law and Regulation* (2009) 24 (11) 559; Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre, King Abdulaziz University 2005) 196.

⁸¹⁷ Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre, King Abdulaziz University 2005) 196.

⁸¹⁸ IPRS was created by the Commerce International Merchant Bank (CIMB) of Malaysia in June 2005, as an Islamic replication of conventional interest-rate swap (IRS) through an Islamic Swap Master Agreement that mirrored the ISDA Master Agreement for IRS in a fully *Shariah*-compliant way. See too Ravindran Ramasamy, Sahn mugam Munusamy, and Mohd Hanif Mohd Helmi, ‘Basic Pricing Methodology for Islamic Profit Rate Swap’, *Global Journal of Management and Business Research* (2011) 11 (5) 38-39; Angelo Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific 2010) 257.

⁸¹⁹ See the official website of Bank Negara Malaysia (BNM), ‘*Shariah Resolutions in Islamic Finance*’, <<http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>> [Accessed 30 September 2013].

⁸²⁰ SAC was established in 1997 as the highest authoritative body for ascertainment of *Shariah* matters relating to Islamic finance in Malaysia. See too: http://www.bnm.gov.my/microsites/financial/pdf/resolutions/04_sac.pdf.

⁸²¹ See the official website of Bank Negara Malaysia (BNM), ‘*Shariah Resolutions in Islamic Finance*’, <<http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>> [Accessed 30 September 2013].

However, some scholars argue that the floating rate payer paying a variable amount would not be *Shariah*-compliant, due to the uncertainty of the amount to be paid.⁸²²

According to Bellalah, IPRS can be structured based on *murabaha* and *waad* contracts.⁸²³ Under IPRS, the parties enter into a series of separate contracts to sell *Shariah*-compliant assets (often London Metal Exchange traded metals). *Murabaha* contracts are structured in two stages. The first stage has generated a fixed profit rate and is structured around a sole *murabaha* contract at a fixed profit rate. At this stage, the fixed-rate payer sells commodities to the floating-rate payer under a *murabaha* contract, and the profit element represents the fixed-profit rate. The second stage involves a series of sequential secondary *murabaha* contracts. In this stage, the floating-rate payer sells commodities to the fixed-rate payer under a *murabaha* contract. The delivery is realised at the date of the contract and the payment coincides with the next primary *murabaha* instalment. The cost price of these commodities equals the cost price element paid by the fixed-rate payer for each instalment. The mark up rate is determined by a floating rate, and the determination of each fixed rate depends on a floating interest rate such as the LIBOR. IPRS might also be structured as a series of *waad* whereby each of the two parties issues an undertaking *waad* to swap relevant fixed and floating rate payments at some point of time.⁸²⁴ In addition, there are several other structures of IPRS such as *tawarruq*⁸²⁵ and *bai-el-Inah*.⁸²⁶

6.5 How Do Islamic Financial Derivatives Work in Saudi Arabia?

While many countries such as Malaysia and Singapore struggle to be the best example of Islamic financial derivatives. Yet despite the increasing demand, Saudi Arabia is still not involved, even though it has the capabilities, experience, Islamic scholars, and financiers as well as the Islamic status in Muslims' hearts, to be in this position. One example of this absence is the lack of regulation of the financial derivatives market, whether conventional or Islamic derivatives.⁸²⁷

⁸²² Sidney Yankson, 'Derivatives in Islamic Finance: A Case for Profit rate Swaps', *Journal of Islamic Economics, Banking and Finance* (2011) 7 (1) 47.

⁸²³ Mondher Bellalah, *Islamic Banking and Finance* (Cambridge Scholars Publishing 2013) 58-59.

⁸²⁴ Ibid.

⁸²⁵ Karen Hunt-Ahmed, *Contemporary Islamic Finance: Innovations, Applications and Best Practices* (John Wiley & Sons 2013) 347.

⁸²⁶ It refers to a contract which involves sale and buy back transactions of an asset by the seller. (<http://www.bnm.gov.my/index.php?ch=7&pg=1038&ac=345&bb=file1>).

⁸²⁷ See the *Al-Eqtisadiyah* newspaper, January 24, 2013, Issue 7045.

Specialists in Islamic finance believe that the SAMA, and the Ministry of Finance for the Kingdom of Saudi Arabia are accountable for not taking the lead in Islamic finance, because there is no independent Capital Market Authority with common criteria for all Islamic finance products. They are also suspicious about the concordance of Islamic finance procedures with present laws, whereby the regulations of Islamic finance institutions are not compatible with the law, and the Banking Control Law (BCL) of 1966 is a traditional one and not suitable for developing new products according to Islamic *Shariah*.⁸²⁸

According to Hasan, despite the legal system of Saudi Arabia being based on Islamic *Shariah*, derived from the *Quran* and the *Sunnah*, the IFIs in Saudi Arabia operate under a strange legal framework, since the existing law of the BCL 1966 is still applicable and has not been repealed or amended to regulate the establishment and existence of the IFIs.⁸²⁹ Hasan adds that despite 15 *sukuk* issuances between 2000 and 2008 and huge Islamic mutual funds in Saudi Arabia, there is no single piece of legislation specifically regulating the implementation of Islamic finance.⁸³⁰

According to Meshal, General Manager of the Raqaba Company for Consultations in the UK, Saudi Arabia is theoretically at the top of the list of those countries able to lead Islamic finance, because all sovereign laws and jurisdiction in Saudi Arabia are based on Islamic *Shariah*. One of these laws is Royal Decree No. 23, dated 15 February 1958, to establish the SAMA, where Article 2 prohibits the paying and receiving of interest,⁸³¹ besides the Islamic identity of Saudi society and the view of Muslims around the world that Saudi Arabia is the centre for executing *Shariah* in every aspect of life.⁸³²

Meshal adds that although Saudi Arabia has the capabilities to take the lead in the field of Islamic finance instead of Malaysia and Bahrain, it is notably late in doing so. He attributes this absence to the lack of initiative of the supervisory authorities to improve, protect and enhance this field and its credibility in front of the whole world. Meshal believes that the absence of supervisory authorities has created a trend for Islamic banks towards making frequent use of *tawarruq* contracts (monetisation of commodities), which is similar to

⁸²⁸ Ibid.

⁸²⁹ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97.

⁸³⁰ Ibid.

⁸³¹ See the Official Website of Saudi Arabia Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx> [Accessed 07 October 2013].

⁸³² See the *Al-Eqtisadiyah* newspaper, January 24, 2013, Issue 7045.

interest-based financing, instead of using other Islamic financial contracting forms.⁸³³ As a result, the reputation of Islamic finance in Saudi Arabia has been distorted, in the eyes of its customers, even though *tawarruq* is permitted by the *Shariah* board.⁸³⁴

He continues by pointing out that in banks that adopt Islamic finance, the same people sit on several different committees or boards, and this has raised questions about the validity of such committees or boards and their decisions. For example, why not have one legal committee or *Shariah* board at the level of the banking sector in Saudi Arabian Monetary Agency? Or why has the Agency not issued common legal criteria for all Islamic financial products? Meshal believes that the establishment of an independent central *Shariah* board in Saudi Arabia, and the adoption of uniform standards of legitimacy, would reduce the emergence of products that do not add value to Islamic banking as *tawarruq*.⁸³⁵

Alnuwayser agrees with Meshal that Saudi Arabia is qualified to become the capital of Islamic banking more than any other country. He considers that SAMA and the Ministry of Finance are responsible for the country's absence in this field which is likely to become the highest economic income, after oil, in the future. Alnuwayser adds that, after the financial crisis in 2007, many of the big banks were impressed by Islamic banking and finance, where the banks were more willing to confront the repercussions of the financial crisis than conventional banks, and especially as they looked more profitable and less exposed to risks than the conventional banks.⁸³⁶

However, SAMA gave no importance to this, and did not even establish a legislative committee for Islamic finance based on clear regulations. Alnuwayser explains that Saudi banks that have Islamic windows do not have a legislative committee to ensure that all the financial products offered to customers comply with Islamic finance principles. He considers that the Ministry of Finance should develop Islamic banks in Saudi Arabia so that they work according to a clear approach under the supervision of an agency specialised in Islamic finance.⁸³⁷

⁸³³ *Murabaha* (trade with mark up or plus sale), *Musharaka* (partnership or joint venture), *Mudaraba* (profit and loss sharing), *Ijara* (leasing contract), *Bai bithaman ajil* (deferred payment sale, credit sale), *Bai salam* (forward selling), *Istisna* (order to manufacture) and *Qardh-al-hasan* (benevolent loans or interest free loan).

⁸³⁴ See the *Al-Eqtisadiyah* newspaper, January 24, 2013, Issue 7045.

⁸³⁵ Ibid.

⁸³⁶ Ibid.

⁸³⁷ Ibid.

Although SAMA regulates and supervises the IFIs under the BCL, there is no standard guideline on *Shariah* governance for Islamic financial institutions. According to Hasan, the practices of the existing Islamic financial institutions in Saudi Arabia show that the *Shariah* governance system is based on a self-regulated approach.⁸³⁸ He adds that the notion of having a *Shariah* governance system within the IFIs is not based on any legal and supervisory requirements but would be a voluntary initiative.⁸³⁹ Therefore, the IFIs in Saudi Arabia are free to adopt their own *Shariah* governance without adhering either locally to SAMA or CMA standards or internationally to AAOIFI standards. For example, the Al-Rajhi bank has established its own *Shariah* guidelines and procedures, known as the *Shariah* Monitoring Guide and *Shariah* Control Guidelines, in order to ensure the proper monitoring and implementation of *Shariah* rulings.⁸⁴⁰

According to Ibn Mani, a member of the council of senior scholars in Saudi Arabia, one of the main reasons for the absence of Islamic financial derivatives in Saudi markets is the lack of a system (law) for the *Shariah* Supervisory Board (SSB) of Islamic banks, where the Saudi banks unilaterally choose the members of the SSBs of the bank.⁸⁴¹ Using the National Commercial Bank of Saudi Arabia (NCB) as a model, the SSB was formed based on a request by the Islamic Banking Development Group in NCB to scientists who meet the Secretariat and science to join the *Shariah* Fatwa for National Commercial Bank products.⁸⁴² This practice comes in the light of the absence of laws to regulate the work of the SSBs.

Ibn Mani recommends finding a common denominator between Islamic banks in Saudi Arabia through the establishment of united SSBs, with SAMA overseeing the coordination between the SSBs. He added that in the case of a difference of opinion or a dispute amongst *Shariah* Boards (SBs), the difference of opinion should be presented to the International Islamic Fiqh Academy.⁸⁴³

According to Hammad, it is possible to find one person being a member of a number of Islamic banks and financial institutions, because of the lack of laws regulating the SSBs. For

⁸³⁸ Zulkifli Hasan, 'Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK', *Kyoto Bulletin of Islamic Area Studies* (2010) 3 (2) 97-98.

⁸³⁹ Ibid.

⁸⁴⁰ See the official website of the Al Rajhi Bank, <<http://www.alrajhibank.com.sa/en/about-us/pages/sharia-group.aspx>> [Accessed 28 October 2013].

⁸⁴¹ Adli Hammad, *The provisions of Islamic investment funds: comparative legal doctrinal study*, Arabic edition (Fouad Bano Press 2010) 172-173.

⁸⁴² Ibid.

⁸⁴³ Adli Hammad, *The provisions of Islamic investment funds: comparative legal doctrinal study*, Arabic edition, (Fouad Bano Press 2010) 173-174.

example, Shaykh Abdullah ibn Mani is a member of many *Shariah* supervisory committees of banks, such as the *Shariah* Board at Gulf Finance House (GFH),⁸⁴⁴ the NCB *Shariah* Board,⁸⁴⁵ the *Shariah* Board at Saudi Hollandi Bank,⁸⁴⁶ the *Shariah* Standards Board at AAOIFI,⁸⁴⁷ the Islamic Fiqh Academy of the Organisation of Islamic Conference (OIC),⁸⁴⁸ and other *Shariah* supervisory committees.

The researcher believes that Saudi Arabia is not ready to apply Islamic financial derivatives along with its compliance with *Shariah* for several reasons. One of the main reasons is the lack of a stand-alone Islamic banking law to regulate those Islamic institutions that conduct banking and financial activities. Currently, in Saudi Arabia, the Islamic banks are regulated by the Banking Control Law (BCL) of 1966.⁸⁴⁹ In contrast, Malaysia's Islamic banks are governed by a separate Act (the Islamic Banking Act 1983 (IBA)).⁸⁵⁰

The absence of a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia has resulted in a questioning of the legal status of *Shariah* rulings and also a conflict of *Shariah* opinion (*fatwa*) by the *Shariah* boards of different IFIs on the same issue. In other words, the IFIs have founded a self-regulatory process within each institution. In addition, they are free to adopt their own *Shariah* governance without adhering either locally to SAMA or CMA standards or internationally to AAOIFI standards. This has caused a lack of the homogeneity that Islamic jurists need in order to be able to issue uniform *fatwas* for some financial products. This problem is due, on the one hand, to the multiplicity of *Shariah* boards and different opinions of Islamic scholars for each bank, and, on the other, to the

⁸⁴⁴ See the official website of Gulf Finance House (GFH), <<http://www.gfh.com/en/about-us/shariaa-board-eng.html>> [Accessed 17 October 2013].

⁸⁴⁵ See the official website of the National Commercial Bank (NCB), <<http://www.alahli.com/en-US/About%20Us/ibdg/Pages/TheNCBShariahBoard.aspx>> [Accessed 17 October 2013].

⁸⁴⁶ See the official website of Saudi Hollandi Bank, <<http://shb.com.sa/en/about/AboutSHB/ShariahBoardmembers.aspx>> [Accessed 17 October 2013].

⁸⁴⁷ See the official website of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), <<http://www.aaofi.com/en/about-aaofi/sharia-standards-board/ssb-committees/>> [Accessed 17 October 2013].

⁸⁴⁸ See the official website of the International Islamic Fiqh Academy, <<http://www.fiqhacademy.org.sa/>> [Accessed 17 October 2013].

⁸⁴⁹ This Act has issued by the Royal Decree No. M/5, dated 12 June 1966. See the official website of the Saudi Arabia Monetary Agency (SAMA), <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>> [Accessed 09 October 2013].

⁸⁵⁰ See the official website of Bank Negara Malaysia (BNM), <<http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802>> [Accessed 09 October 2013].

uncertainty on the part of clients as to whether a product developed in one jurisdiction is *Shariah*-compliant in a neighbouring jurisdiction.⁸⁵¹

Another main issue is the absence of a national centralised *Shariah* supervisory board. In Saudi Arabia, there is no independent central *Shariah* board to regulate and supervise Islamic banking activities. Currently, SAMA supervises and regulates Islamic institutions that conduct banking and financial activities side-by-side with conventional commercial banking businesses under Royal Decree No. M/5, dated 11 June 1966.⁸⁵² However, in Malaysia, the *Shariah* Advisory Council (SAC) regulates and supervises Islamic banking activities. SAC is the highest *Shariah* authority in Islamic finance, responsible for validating all Islamic financial products to ensure their compatibility with *Shariah* principles.⁸⁵³

This absence of a central *Shariah* supervisory board raises the probability of conflict in opinions (*fatwas*) between Islamic scholars in Saudi Arabia. These differing opinions may result in significant damage to the IFIs in addition to breach of confidence among investors.⁸⁵⁴ An example of this conflict between Islamic scholars in Saudi Arabia was mentioned in Chapter four, in relation to the initial public offering of the Yanbu National Petrochemical Company (YANSAB).

The researcher recommends the establishment of a stand-alone Islamic banking law, drafted by experts in the fields of law and Islamic finance, whose qualifications include a PhD in Islamic finance. This stand-alone Islamic banking law must be consistent with the provisions and principles of *Shariah* in order to fill the legislative and regulatory gap for Islamic banking and finance in Saudi Arabia. Article 1 of the Basic Law of Governance in Saudi Arabia stipulates that the constitution of the Kingdom of Saudi Arabia is the Holy *Quran* and the *Sunnah*.⁸⁵⁵ Therefore, any bill must take into account the principles of *Shariah* (the Holy *Quran* and the *Sunnah*).

⁸⁵¹ Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons 2011) 184.

⁸⁵² See the official website of Saudi Arabia Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx> [Accessed 09 October 2013].

⁸⁵³ See the official website of Bank Negara Malaysia (BNM), <http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802> [Accessed 09 October 2013].

⁸⁵⁴ Abdullah Al Elsheikh & Joseph Tanega, 'Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia', *Law and Financial Markets Review* (2011) 5 (3) 194.

⁸⁵⁵ See the official website of the Bureau of Experts at the Council of Ministers, <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25> [Accessed 12 October 2013].

The researcher also recommends the establishment of an independent body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities including *takaful* business, instead of SAMA. Members of the SSAC should be qualified in banking, finance, law and the application of *Shariah*, particularly in the areas of Islamic banking and finance. The number of members must be at least 25. The researcher further recommends that the SSAC should look into issues related to Islamic banks and their customers under the name “the Committee for Settlement of Banking Disputes” instead of the Committee for Settlement of Banking Disputes in SAMA which was issued, formed of three competent members from SAMA under a Royal Order on 1/3/1987.⁸⁵⁶ The Committee for Settlement of Banking Disputes in SAMA would continue to look into issues related to conventional banks and their customers, while the SSAC would look into issues related to Islamic banks and their customers. The lack of commercial courts in Saudi Arabia and the need for three competent members from SAMA to consider the banking disputes support the researcher’s view. The researcher’s view is that the banking disputes need a specialised body such as the SSAC and experts in Islamic finance to look into banking issues. The SSAC would not be a court and its decision would not be final and binding, but it would give an opinion. It would just be a settlement committee, and the binding resolution would be by specialised commercial courts.

The researcher believes that the establishment of the proposed SSAC is not difficult in Saudi Arabia, because the system of governance in the Kingdom of Saudi Arabia is monarchical. Under Royal Order No: A/90 dated 1 March 1992 of the Basic Law of Governance, Article 5/A stipulates that “the system of governance in the Kingdom of Saudi Arabia shall be monarchical”.⁸⁵⁷ Therefore, under Articles 5/A, 57, 58 and 62 of the Basic Law of Governance, the establishment of an independent body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities in Saudi Arabia is the king’s prerogative. For example, Saudi Arabia's King Abdullah bin Abdulaziz issued a Royal Decree establishing an Anti-Corruption Commission (ACC) to monitor and observe government departments.⁸⁵⁸ The ACC is directly connected to the King of Saudi Arabia under Royal Decree No. A/65 dated 18 March 2011.⁸⁵⁹

⁸⁵⁶ See the official website of the Saudi Arabia Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAHistory.aspx> [Accessed 10 October 2013].

⁸⁵⁷ See the official website of the Bureau of Experts at the Council of Ministers, <http://boe.gov.sa/ViewStaticPage.aspx?lang=en&PageID=25> [Accessed 12 October 2013].

⁸⁵⁸ See the official website of the National Anti-Corruption Commission,

The researcher recommends adopting AAOIFI's standards and guidelines and the IFSB guidelines in IFIs such as accounting standards, auditing standards and governance standards until the establishment of the proposed SSAC. The SSAC would provide guidelines for *Shariah* governance framework for the Islamic financial institutions to ensure the proper monitoring and implementation system of *Shariah* rulings on the IFIs. The researcher believes that it is also important to amend the Banking Control Law (BCL) issued under Royal Decree No. M/5 dated 11 June 1966, and the Capital Market Law, issued by Royal Decree No. (M/30) dated 31 July 2003 in order make them accommodate standards issued from international bodies specialised in the field of Islamic finance.

The researcher also recommends that the Saudi government should set up specialised commercial courts to look into commercial issues including Islamic banking issues. Such courts should take the opinion of SSAC in the Islamic banking and finance issues. Both the specialised commercial courts and SSAC should consider standards and recommendations that have been issued and developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); such as governance standards, *Shariah* standards, accounting standards, auditing standards, and ethics standards.⁸⁶⁰ They should also consider decisions and recommendations that have been issued by the Islamic Fiqh Council (IFC) regarding Islamic banking and finance, such as Resolution No: 85 (2/9) [1] of the International Islamic Fiqh Academy, Salam contract and its contemporary applications.⁸⁶¹

6.6 Proposed Legislative and Regulatory Framework for Islamic Banking and Finance Including Islamic Financial Derivatives in Saudi Arabia

As mentioned, in Saudi Arabia there is no specific law governing Islamic banking and finance including Islamic financial derivatives in spite of the importance of regulating and supervising Islamic financial activities. There are two acts for regulating banking business and securities in Saudi Arabia. The first one is the Banking Control Law (BCL), issued under Royal Decree No. M/5, dated 11 June 1966, which is considered the main legislation to

<<http://www.nazaha.gov.sa/en/About/Pages/Establishment.aspx>> [Accessed 10 October 2013].

⁸⁵⁹ Ibid.

⁸⁶⁰ See the official website of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI),

<<http://www.aaofi.com/aaofi/Publications/KeyPublications/tabid/88/language/en-US/Default.aspx>> [Accessed 12 October 2013].

⁸⁶¹ See the official website of the Islamic Fiqh Council (IFC), <<http://www.fiqhacademy.org.sa/qrarat/9-2.htm>> [Accessed 12 October 2013].

regulate all banking business in Saudi Arabia.⁸⁶² Under this law, SAMA is responsible for the regulation of Saudi banks. For example, Article 3 of the BCL stipulates that all applications to carry on a banking business in Saudi Arabia shall be addressed to SAMA.⁸⁶³

The second act is the Capital Market Law, issued by Royal Decree No. (M/30) dated 31/ July 2003. Under this act, the Capital Market Authority (CMA) is responsible for regulating the Saudi Arabian Capital Market and creating an appropriate investment environment, boosting confidence, reinforcing transparency and disclosure standards in all listed companies, and protecting investors and dealers from illegal acts in the market.⁸⁶⁴

Neither act mentions Islamic banking, nor have SAMA and CMA issued a single document pertaining to Islamic banking and financial business, in contrast to the central bank of Malaysia (Bank Negara Malaysia (BNM)), and the Securities Commission Malaysia (SC), or even the Financial Services Authority (FSA) in the UK, which have issued numerous documents and guidelines pertaining to Islamic banking and finance. For example, in March 1993, BNM introduced a scheme known as an interest-free Banking Scheme which allows existing banking institutions to offer Islamic banking products through their existing infrastructure and branch network.⁸⁶⁵ In 2005, BNM issued its Guidelines on the Governance of *Shariah* Committees, known as BNM/GPS 1, which regulates the governance of the *Shariah* Committee of IFIs in Malaysia.⁸⁶⁶ BNM has also issued Guidelines on the Disclosure of Reports and Financial Statements of Islamic Banks, known as BNM/GPS8-i.⁸⁶⁷ The *Shariah* framework is set by the SAC of BNM, and this SAC approved several financing techniques and capital market instruments.⁸⁶⁸

In addition, some Gulf Cooperation Council (GCC) countries have mentioned Islamic banking in their legislation. For example, in Kuwait, the Central Bank of Law was amended

⁸⁶² See the official website of the Saudi Arabia Monetary Agency (SAMA), <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx> [Accessed 18 October 2013].

⁸⁶³ Ibid.

⁸⁶⁴ See the official website of the Capital Market Authority (CMA), <http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx> [Accessed 18 October 2013].

⁸⁶⁵ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Pacific-Basin Finance Journal* (2009) 17 (1) 130.

⁸⁶⁶ Hjh Siti Faridah Abd Jabbar, 'The governance of Shari'a advisers of Islamic financial institutions: the practice in Malaysia', *Company Lawyer* (2009) 30 (10) 312.

⁸⁶⁷ Zulkifli Hasan & Zulkifli bin Hasan, *Shariah Governance in Islamic Banks* (Edinburgh University Press 2012) 109.

⁸⁶⁸ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar Publishing Limited 2007) 135.

to bring the Islamic banks formally under the jurisdiction of the Central Bank of Kuwait (CBK).⁸⁶⁹ In Bahrain, the Central Bank of Bahrain (CBB) issued a rulebook for Islamic Banks.⁸⁷⁰ In the United Arab Emirates (UAE), Federal Law No. 6 of 1985 mentions ten articles regarding Islamic banking, financial institutions and investment companies.⁸⁷¹

The researcher believes that there is an urgent need to enact a special law to regulate and supervise Islamic banking and financial services in Saudi Arabia, like the Central Bank of Malaysia Act 2009 (CBA), the Banking Regulation Act 2003 in Sudan, and the Islamic Banking Law 1983 in Iran. To address this legislation gap, the researcher proposes a legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia. This framework consists of three chapters and key elements, as follows:

Chapter 1: Licensing Requirement

- a. All applications, for the granting of licences to establish or conduct an Islamic bank or cooperative insurance company (*takaful*) or Islamic banking business or Islamic financial business in the Kingdom of Saudi Arabia shall be addressed to the Saudi Arabian Monetary Agency (SAMA) which will study the applications after obtaining all the necessary information with the Saudi *Shariah* Advisory Council, and submit their recommendations to the Ministry of Finance for endorsement.
- b. The licence for an Islamic bank or cooperative insurance company (*takaful*) shall stipulate the following:
 - i. Any licensed institution carrying on an Islamic banking business or Islamic financial business shall not involve any element that is not approved by the religion of Islam such as dealing in transactions that contain excessive risk or speculation or investment in businesses related to alcohol, pork-related products, conventional financial services, pornography, weapons and defence.
 - ii. Any licensed institution carrying on an Islamic banking business or Islamic financial business shall not involve usury or interest (*riba*), uncertainty (*gharar*), or gambling (*maysir*).

⁸⁶⁹ Ibid., p. 122.

⁸⁷⁰ See the official website of the Central Bank of Bahrain (CBB), <http://www.cbb.gov.bh/page-p-cbb_rule_book.htm> [Accessed 20 October 2013].

⁸⁷¹ Federal Law No. 6 of 1985.

- iii. Any licensed institution shall consult the Saudi *Shariah* Advisory Council with respect to carrying on an Islamic banking business or Islamic financial business.
- iv. The cooperative insurance company (*takaful*) acts as the agent for the fund management and receives a fee for underwriting the fund in a *wakala* contract, while it acts as the fund manager for managing investments and sharing the profit from the investment of the *takaful* fund in a *mudaraba* contract.

Chapter 2: The Saudi *Shariah* Advisory Council (SSAC)

- a. Establishment of the Saudi *Shariah* Advisory Council. There shall be established an independent body known as the Saudi *Shariah* Advisory Council (SSAC), under Royal Decree from the King of Saudi Arabia under the powers granted to him under the 58th Article of the Basic Law of Governance issued by Royal Order No. A / 90 dated 01 March 1992. The Saudi *Shariah* Advisory Council shall be the highest *Shariah* authority for the determination of *Shariah* for Islamic financial business in the Kingdom of Saudi Arabia. The Saudi *Shariah* Advisory Council shall be given authority for the ascertainment of *Shariah* for the purposes of Islamic financial business, Islamic banking business, Islamic bonds (*sukuk*), *takaful* business, Islamic financial derivatives, and Islamic development financial business, or any other Islamic financial business. The Saudi *Shariah* Advisory Council is the final arbiter in the interpretation of *Shariah* principles on Islamic banking and financial business.
- b. Functions. The Saudi *Shariah* Advisory Council shall have the following functions:
 - i. To regulate all Islamic banking business and Islamic finance business including Islamic bonds (*sukuk*), cooperative insurance (*takaful*), and Islamic financial derivatives.
 - ii. Effective supervision of Islamic banks, cooperative insurance companies and Islamic finance companies to ensure that all internal and external operations comply with *Shariah* principles.
 - iii. To contribute to the realisation of the bank's Islamic banking strategy through supporting plans and policies necessary for the bank's compliance with the provisions of *Shariah*.
 - iv. To ascertain that the operations of Islamic financial institutions or Islamic windows of conventional banks are undertaken according to *Shariah* principles.

- v. To issue *fatwas*, *Shariah* rulings, *Shariah* standards, accounting standards, auditing standards, governance standards, and guidelines concerning products, services and operations of Islamic financial institutions.
 - vi. To establish a sound and robust *Shariah* governance framework for Islamic financial institutions.
 - vii. To regulate the governance of the *Shariah* Committees at the Islamic financial institutions by setting out the rules, regulations and procedures in the establishment of the *Shariah* Committees.
 - viii. To advise the central bank of Saudi Arabia or any Islamic financial institution or an internal *Shariah* committee established within each Islamic financial institution on any *Shariah* issue relating to Islamic financial business.
 - ix. To innovate and develop new financial products and services in line with the precepts of *Shariah*.
 - x. To settle financial and commercial disputes between the Islamic financial institution and others – whether the dispute is between the Islamic financial institution and the investors or shareholders, or between the Islamic financial institution and the government, or between public legal persons and private legal persons, or one of the public or private sector companies or individuals – through the arbitration centre of the Saudi *Shariah* Advisory Council.
 - xi. Coordination and cooperation with specialised international bodies in the field of Islamic banking and finance, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Development Bank (IDB), International Islamic *Fiqh* Academy (IIFA), and the *Shariah* Advisory Council of Bank Negara Malaysia (SAC).
 - xii. To form a *Shariah* committee if the Islamic financial institutions require their own *Shariah* committee to be established.
- c. Functions of the *Shariah* committee:
- i. Verifying that the Islamic financial institutions' transactions comply with *fatwas* by the Saudi *Shariah* Advisory Council.
 - ii. Issuing an annual report to the Saudi *Shariah* Advisory Council that all financial transactions comply with *Shariah* principles.
 - iii. Educating employees in Islamic financial institutions through training courses so that they are legally qualified to complete the tasks assigned to them.

- iv. The *Shariah* committee is responsible for calculating and paying *zakat* (purification).
 - v. The members of the *Shariah* committee shall be appointed by the Saudi *Shariah* Advisory Council for three years.
 - vi. A member from the *Shariah* committee of Islamic financial institutions shall be appointed by the SSAC as an internal inspector to ensure that all internal and external operations comply with the provisions of *Shariah*.
 - vii. No member of the *Shariah* committee shall be a member of another board within the same industry.
 - viii. The members of the *Shariah* committee shall not be nor have been employed by an Islamic Financial Institution or any of its related companies for the current or previous financial year.
- d. Qualifications of the Saudi *Shariah* Advisory Council and the *Shariah* committee members.
- i. Every member of the Saudi *Shariah* Advisory Council and every member of the *Shariah* committee shall be a Muslim individual.
 - ii. The majority of the Saudi *Shariah* Advisory members shall hold a Doctorate degree in Islamic banking and finance.
 - iii. All the *Shariah* committee members shall have a Masters degree in Islamic banking and finance.
 - iv. All members of the Saudi *Shariah* Advisory Council and the *Shariah* committee members should be able to demonstrate strong proficiency in and knowledge of both written and oral Arabic, and the majority of them should also have a good understanding of the English language.
 - v. The Saudi *Shariah* Advisory Council and the *Shariah* committee members preferably shall comprise members of diverse backgrounds in terms of qualification, knowledge and experience.
- e. Appointment of members to the Saudi *Shariah* Advisory Council.
- i. The President and members of the Saudi *Shariah* Advisory Council shall be appointed by the King of Saudi Arabia on the advice of the Minister of Finance after consultation with the central bank of Saudi Arabia.
 - ii. The President of the Saudi *Shariah* Advisory Council shall be appointed on a Minister's rank.

- iii. The members of the Saudi *Shariah* Advisory Council shall be composed of eleven members including the President appointed for four years.
 - iv. The members of the Saudi *Shariah* Advisory Council shall be elected from among *Shariah* scholars, lawyers, bankers, accountants and central bankers as well as from among Islamic financial professionals and scholars.
 - v. No member of the Saudi *Shariah* Advisory Council shall be a member of another board within the same industry.
 - vi. The members of the Saudi *Shariah* Advisory Council shall not be nor have been employed by an Islamic Financial Institution or any related companies for the current or previous financial year.
- f. Secretariat to the Saudi *Shariah* Advisory Council. The Saudi *Shariah* Advisory Council may establish a secretariat and such other committees as it considers necessary to assist the Saudi *Shariah* Advisory Council in carrying out its functions; and appoint any officer of the Saudi *Shariah* Advisory Council or any other person to be a member of the secretariat or such other committees.
 - g. Reference to the Saudi *Shariah* Advisory Council for any ruling from court or arbitrator. In any proceedings relating to Islamic financial business, the court or arbitrator shall take into consideration any published rulings of the Saudi *Shariah* Advisory Council.
 - h. Effect of *Shariah* rulings. Any ruling made by the Saudi *Shariah* Advisory Council shall be binding on the Islamic financial institutions.
 - i. *Shariah* Advisory Council ruling prevails. Where the ruling given by a *Shariah* committee constituted by an Islamic financial institution or by Islamic windows of conventional banks is different from the ruling given by the Saudi *Shariah* Advisory Council, the ruling of the Saudi *Shariah* Advisory Council shall prevail.

Chapter 3: The *Shariah* Governance Framework for Islamic Financial Institutions

- a. The Saudi Arabian Monetary Agency (SAMA) and the Saudi *Shariah* Advisory Council are responsible for establishing a sound and robust *Shariah* governance framework with emphasis placed on the roles of key functionalities in ensuring effective implementation of the *Shariah* governance framework.

- b. Under this framework, the Saudi *Shariah* Advisory Council will be responsible for the overall *Shariah* oversight of Islamic financial institutions and the effective functioning of the *Shariah* governance structure, policies and processes.
- c. Regulation, oversight, accountability and responsibility.
 - i. Regulation. the Saudi *Shariah* Advisory Council regulates all Islamic banking business and Islamic finance business including Islamic bonds (*sukuk*), cooperative insurance (*takaful*) and Islamic financial derivatives. The Saudi *Shariah* Advisory Council regulates the governance of the *Shariah* Committees at the Islamic financial institutions by setting out the rules, regulations and procedures in the establishment of the *Shariah* Committee.
 - ii. Oversight. The Saudi *Shariah* Advisory Council is responsible for effective supervision of Islamic banks, cooperative insurance companies and Islamic finance companies to ensure that all internal and external operations comply with *Shariah* rules and principles. The *Shariah* committee shall monitor the activities and the implementation of *Shariah* rulings with the assistance of the *Shariah* Control Department to facilitate greater transparency and disclosure in financial reporting and to maximise public confidence in Islamic financial institutions of the application of *Shariah* rules and principles.
 - iii. Accountability and responsibility.
 The Saudi *Shariah* Advisory Council is ultimately accountable and responsible for the overall *Shariah* governance framework and for *Shariah* compliance of the Islamic financial institutions, through putting in place the appropriate mechanisms.
 The Saudi *Shariah* Advisory Council is responsible for issuing *fatwas*, *Shariah* rulings, *Shariah* standards, accounting standards, auditing standards, governance standards, and guidelines concerning products, services and operations of Islamic financial institutions.
 The members of the *Shariah* committee shall be appointed by the Saudi *Shariah* Advisory Council for three years, based on the recommendation of the Nominating Committee in the Islamic financial institutions.
 The *Shariah* committee is responsible for verifying that the Islamic financial institutions' transactions comply with *fatwas* issued by the Saudi *Shariah* Advisory Council.

The *Shariah* committee is responsible for issuing an annual report to the general assembly of Islamic financial institutions, and the Saudi *Shariah* Advisory Council shows that all financial transactions comply with *Shariah* principles.

The *Shariah* committee is responsible for calculating and paying *zakat* (purification).

Employees shall be educated in the Islamic financial institutions through training courses so that they are legally qualified to complete the tasks assigned to them.

The *Shariah* Committee shall be accountable and responsible for all its decisions, opinions and views related to *Shariah* matters.

6.7 Legal Challenges in Applying the Proposed Framework for Islamic Banking and Finance in Saudi Arabia

There are some challenges that prevent the application of the proposed framework. The first challenge is the restriction of *Shariah fatwa*. Saudi Arabia's King Abdullah issued Royal Order No: B/13876 dated 12 August 2010 to restrict *Shariah fatwa* on the Council of Senior Scholars in Saudi Arabia (also known as the Senior Council of *Ulema*).⁸⁷² This royal order prevents any body or person from practising the *fatwa* except the Council of Senior Scholars. To address this issue, this royal order needs to be amended so as to appoint the Saudi *Shariah* Advisory Council with the Council of Senior Scholars as the body that is responsible for issuing *Shariah fatwa* regarding Islamic financial business, Islamic banking business, Islamic bonds (*sukuk*), *takaful* business, Islamic financial derivatives, Islamic development financial business, or any other Islamic financial business.

Another challenge that should be clear to all Islamic financial institutions is liquidity risk. In the case of these institutions' exposure to the liquidity crisis, SAMA will not support or provide the necessary liquidity to them. It is known that SAMA as a central bank acts as the lender of last resort if commercial banks encounter any liquidity risk, by lending them the necessary money but requiring them to return the money with interest later. Therefore, the lending policy in SAMA is based on interest payment. It is known that Islamic financial institutions cannot borrow money on an interest basis either from SAMA or any other body

⁸⁷² See the official website of the Bureau of Experts at the Council of Ministers, <<http://www.boe.gov.sa/MainDefault.aspx?lang=ar>> [Accessed 07 November 2013].

such as the International Monetary Fund (IMF), because interest (*riba*) is forbidden in Islam. So what is the solution? The solution from the researcher's point of view is that Islamic financial institutions enter into a contract with the Islamic Development Bank (IDB) in Saudi Arabia whereby the IDB will grant loans without interest to the IFIs to address their crisis.

Finally, an amendment to the law of supervision of cooperative insurance companies was issued by Royal Decree No. M/32 on 01/08/2003, and its implementing regulation was issued by Ministerial Decision No. 1/596 on 20/04/2004 in order to appoint the Saudi *Shariah* Advisory Council as the body responsible for overseeing and regulating Islamic financial institutions, including cooperative insurance companies.

The researcher hopes that this proposal will be taken into consideration by SAMA and the Ministry of Finance. The proposal is intended as the first step towards the enactment of a law regulating Islamic financial institutions in Saudi Arabia. The researcher also recommends taking advantage of the Malaysian experience where the Islamic Banking Act (IBA 1983) and the Bank and Financial Institutions Act (BAFIA 1993, amended) were enacted in order to cater for Islamic banking practices.⁸⁷³ Malaysia also established the *Shariah* Advisory Council of Bank Negara Malaysia (SAC) in May 1997 as the highest *Shariah* authority in Islamic finance in Malaysia.⁸⁷⁴

6.8 Summary

This chapter has aimed to provide a comprehensive and critical review of Islamic financial derivatives in Saudi Arabia, including their concept, mechanism, principles, practices and models, as an Islamic alternative to conventional derivatives. This chapter has also examined whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*. The research question of this chapter has discussed how Islamic financial derivatives work in Saudi Arabia.

The researcher found that there is no special law to regulate and supervise Islamic banking and financial services in Saudi Arabia. The Saudi Arabian Monetary Agency (SAMA) regulates and supervises Islamic institutions that conduct banking and financial activities side-by-side with conventional commercial banking businesses under the Banking Control

⁸⁷³ Saiful Rosly, *Critical Issues on Islamic Banking and Financial Markets: Islamic Economics, Banking and Finance, Investments, Takaful and Financial Planning* (Author House 2005) 66.

⁸⁷⁴ See the official website of Bank Negara Malaysia (BNM), <http://www.bnm.gov.my/index.php?ch=7&pg=715&ac=802> [Accessed 01 November 2013].

Law (BCL) of 1966. Unlike Malaysia, there is no independent central *Shariah* board to regulate and supervise Islamic banking and financial activities in Saudi Arabia. The researcher also found that there are no specialised commercial courts in Saudi Arabia to look into commercial issues including Islamic banking issues.

The researcher recommended the enactment of a special law for Islamic banking and finance, drafted by experts in the fields of law and Islamic finance in Saudi Arabia. The researcher also recommended establishing an independent body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities including *takaful* business, instead of SAMA. The researcher recommended adopting AAOIFI's standards and guidelines and the IFSB guidelines in IFIs such as accounting standards, auditing standards and governance standards until the establishment of the proposed SSAC. The researcher further recommended the establishment of specialised commercial courts to look into commercial issues including Islamic banking issues in Saudi Arabia. In addition, the researcher recommended transferring the Malaysian experience in the field of Islamic banking and finance to Saudi Arabia with some modifications that would be commensurate with the nature of the Saudi regime.

In this chapter, the researcher proposed an initial legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia. The researcher examined the legal challenges in applying the proposed framework in Saudi Arabia, and offered possible solutions to meet those challenges. The researcher hopes that SAMA and the Ministry of Finance will consider this framework and make it a first step towards the enactment of a law regulating Islamic financial institutions in Saudi Arabia.

CHAPTER SEVEN: CONCLUSION AND RECOMMENDATIONS

7.1 Introduction

The final chapter summarises the main conclusions, based on the research undertaken from the critical literature review and comparative analysis. This chapter presents the major findings that were discussed in Chapters Four, Five and Six. It also provides recommendations for reforming and improving the existing laws and regulations governing Islamic banking and financial activities in Saudi Arabia. It then suggests ideas for further research and presents a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia as a main contribution to research knowledge.

The main purpose of this research was to examine whether the current practices of Islamic banking and financial activities in Saudi Arabia, including the current uses of *sukuk* (Islamic bonds), the models of *takaful* (Islamic insurance) and accepted risk transfer mechanisms in Islamic structured finance (Islamic derivatives), are compatible with the principles of *Shariah*.

7.2 Conclusion

The first chapter introduced the research questions and stated the research objectives, as well as explaining the rationale of choosing the research topic. It also briefly discussed the research methodology and research scope and limitation. An outline of the thesis was also presented in this chapter.

Chapter Two provided background information to the Saudi legal structure and Islamic banking and financial systems in Saudi Arabia. It gave a brief overview of the meaning of *Shariah* and its legal sources, and also the main *Sunni* schools (*madhhab*). It also explained about the authorities responsible for the regulation and supervision of Islamic banking and financial activities in Saudi Arabia. This chapter answered the research question about the basic laws for Islamic banking and financial activities including Islamic bonds, Islamic insurance and Islamic derivatives in Saudi Arabia.

This second chapter explained that the constitution of the Kingdom of Saudi Arabia is based on *Shariah*.⁸⁷⁵ *Shariah* governs all aspects of Islamic life, including religion and economics.

⁸⁷⁵ Basic Law of Governance 1992, Art. 1.

Shariah derives its provisions from the primary and secondary sources. The Holy *Quran* and *Sunnah* of Prophet Muhammad are considered the primary sources of *Shariah*, while Islamic scholarly consensus (*ijma*) and analogical reasoning by Muslim judges (*Qiyas*) are secondary sources. The primary sources of *Shariah* govern all administrative regulations of the State.⁸⁷⁶ In Saudi Arabia, *Shariah* is interpreted by Islamic judges (*qadis*) who have been influenced by the *Hanbali madhhab* (school) of Islamic jurisprudence which is applied by Saudi courts. In *Shariah*, there are four Islamic *Sunni* schools, the *Hanafi*, *Maliki*, *Shafii* and *Hanbali* schools.⁸⁷⁷

The conclusion reached in this chapter was that there are three laws to regulate and supervise all Islamic banking and financial activities in Saudi Arabia. The first law is the Banking Control Law (BCL) issued under Royal Decree No. M/5 dated 11/6/1966, which is considered the main legislation to regulate all banking business in Saudi Arabia. Under this law, SAMA is responsible for the regulation of Saudi banks.⁸⁷⁸ The second is the Law of Supervision of Cooperative Insurance Companies issued by Royal Decree No. M/32 on 01/08/2003, and its implementing regulations issued by the Ministerial Decision No. 1/596 on 20/04/2004 to regulate and supervise the cooperative insurance companies sector in Saudi Arabia. Under this law, SAMA is considered the regulatory authority for regulating and supervising the cooperative insurance companies in Saudi Arabia.⁸⁷⁹ The third law is the Capital Market Law, issued by Royal Decree No. M/30, dated 31/07/2003. Under this law, the Capital Market Authority (CMA) is responsible for regulating the Saudi Arabian Capital Market and creating an appropriate investment environment, boosting confidence, reinforcing transparency and disclosure standards in all listed companies, and protecting investors and dealers from illegal acts in the market.⁸⁸⁰

Chapter Three reviewed the body of knowledge concerning Islamic finance laws, principles, distinguishing features, contracting forms, risks and challenges from the *Shariah* point of view. It also explained the nature and scope of Islamic finance, using a comparative approach

⁸⁷⁶ Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', *Science Direct* (2009) 17 (1) 128.

⁸⁷⁷ Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009) 16.

⁸⁷⁸ See the official website of the Saudi Arabia Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx> [Accessed 18 October 2013].

⁸⁷⁹ See the official website of the Saudi Arabian Monetary Agency (SAMA), available at: <http://www.sama.gov.sa/sites/SAMAEN/Insurance/Pages/LawsandRegulations.aspx> [Accessed 30 November 2013].

⁸⁸⁰ See the official website of the Capital Market Authority (CMA), available at: <http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx> [Accessed 18 October 2013].

to make a comparison with the conventional system so as to broaden the understanding of the subject. This chapter highlighted the main question of this research through a review of Islamic financial contracting forms, which are applied in Islamic banks or by Islamic windows in conventional banks.

This third chapter concluded that Islamic finance is based on the principles of *Shariah*, and involves the sharing of profits and losses. Islamic finance includes a set of financial contracts which are compatible with *Shariah* principles. Such contracts are offered by Islamic banks and the Islamic banking windows in conventional banks. The major financial principles of *Shariah* are the prohibitions on interest (*riba*), either *riba an-Nasia* or *riba al-Fadl*; gambling (*qimar/maisir*) and uncertainty (*gharar*), but the most important of these is the prohibition of interest (*riba*). Therefore, all Islamic banks and financial institutions must perform their activities on the basis of non-interest or interest-free banking. Instead of interest or usury, *Shariah* seeks to promote ethical behaviour and entrepreneurship, and to encourage risk-sharing and equitable distribution of wealth in order to bring about social and economic justice and the preservation of property rights.

Islamic finance faces a number of risks in its operations, due to the nature of its balance sheet and compliance with *Shariah*; these risks are Credit risk, Liquidity risk, Market risk and Operational risk. Islamic banks are just as exposed to financial risks in their present contracts as conventional banks are, but the nature of the risks faced by Islamic banks is complex and difficult to mitigate. In addition, Islamic finance also faces a set of challenges. It could be claimed that the biggest reason for these risks and challenges is the *Shariah* risk, which is exemplified in the multiplicity of *Shariah* boards and the different opinions of Islamic scholars in each bank to ensure that Islamic financial products and activities are compliant with *Shariah*. In this regard, *Shariah* scholars need to learn more about conventional finance in order to reduce the risks and challenges that face Islamic banks and to benefit from the experiences of conventional banks in this field.

Chapter Four provided a comprehensive and critical review of *sukuk* issuance in Saudi Arabia, its concept, mechanism, principles, practices and models as an Islamic alternative to conventional bonds. The focus of this chapter was on the regulatory framework of the issuance of *sukuk* in Saudi Arabia from the *Shariah* point of view. This chapter discussed the difference between *sukuk* and conventional bonds on the basis of contract legitimacy and *Shariah*-compliance. It also discussed why conventional bonds are prohibited and

unacceptable in *Shariah*. The aim of this chapter was to examine whether the current uses of *sukuk* provided by the CMA are compatible with the principles of *Shariah*.

This fourth chapter concluded that the issuance of *sukuk* in Saudi Arabia is regulated and supervised side-by-side with the issuance of shares and debt instruments by the Capital Market Authority under the CMA Listing Rules and the CMA Offer of Securities Regulations. Islamic *sukuk* offer a mechanism of partial ownership under a financial obligation (known as *sukuk murabaha*), business (*sukuk Al musharaka*), investment (*sukuk Al istithmar*), project (*sukuk Al istisna*), and asset (*sukuk Al ijarah*). *Sukuk* issuance in Saudi Arabia faces a set of challenges, perhaps the most important of which is the lack of a legislative and regulatory framework for *sukuk* issuance. The issuance of *sukuk* and convention debt instruments share many common features, especially assets-backed bonds. However, there are two important differences between them. With regard to the future flow of money, in the case of conventional bonds, investors are ensured a fixed rate of return or interest on the maturity of bond, while the financial structure of *sukuk* is based upon the exchange of those assets that have been approved with a few scales, instead of the exchange of money with the certificates alone. The second major difference can be recognised in terms of financial situations where a bond issuer cannot repay the debt and interest to investors; in these financial circumstances, a bond holder may lose his/her investment, as the contractual obligations of the bond do not guarantee the security of recovering the principal investment. In the case of *sukuk*, investors can claim some of their investment through collateral to the contract *sukuk*.

Chapter Five reviewed the body of knowledge concerning Islamic insurance, its principles, regulation and supervision, challenges and its models from the *Shariah* point of view. The aim of this chapter was to determine the legal conflict between the law of supervision of cooperative insurance companies in Saudi Arabia, and its implementing regulations. This chapter discussed the difference between *takaful* and conventional insurance, and why conventional insurance is prohibited and unacceptable in *Shariah*. This chapter answered the research question about to what extent the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations comply with *Shariah* law.

In Saudi Arabia, Islamic insurance is regulated and supervised side-by-side with conventional insurance by SAMA under the Law of Supervision of Cooperative Insurance Companies and its implementing regulations. The three main operational models used in the *takaful* industry

in Saudi Arabia are the *mudarabah*, *wakala* and hybrid ones. The general principles of *takaful* are the same as those of Islamic finance, which is the prohibition of interest or usury (*riba*), uncertainty (*gharar*), and gambling (*maisir*), but *takaful* as a contract of mutual insurance is based on the principles of mutual cooperation (*taawun*) and donation (*tabaru*), cooperative risk sharing, mutual responsibility, mutual protection, and solidarity among groups of participants.

Conventional insurance is prohibited in Islam because it involves elements of uncertainty (*gharar*) in the subject matter. Moreover, *gharar* can exist in conventional insurance in four forms: in the outcome, in the existence, in the results of the exchange and in the contract period. Conventional insurance also involves *riba* (interest) both directly and indirectly in its investment activities: the direct involvement of *riba* is an excess on one side in the case of exchange between the amount of the premiums and the sum insured. Investment in interest-based businesses by the insurer refers to the indirect involvement of the policyholder in *riba*-based transactions such as putting insurance funds in interest-bearing instruments such as bond and loans. In addition, conventional insurance involves gambling, where one party is always hoping for a gain, resulting in a loss for another party.

Chapter Six gave a comprehensive and critical review of Islamic financial derivatives as an alternative to conventional derivatives in Saudi Arabia. The aim of this chapter was to examine whether the current uses of accepted risk transfer mechanisms in Islamic structured finance are compatible with the principles of *Shariah*. This chapter offered a critical and comparative analysis of the principles and practices of derivatives in Islamic and conventional finance and also discussed the difference between them. It then discussed why derivatives in conventional finance are prohibited and unacceptable in *Shariah*. This sixth chapter critically analysed how Islamic financial derivatives work in Saudi Arabia from the *Shariah* point of view. In this same chapter, the researcher proposed a legislative and regulatory framework for Islamic banking and finance including Islamic financial derivatives in Saudi Arabia. The chapter examined the legal challenges in applying the proposed framework for Islamic banking and finance in Saudi Arabia, and provided solutions to meet those challenges.

Islamic financial derivatives in Saudi Arabia are regulated and supervised by SAMA under the Banking Control Law (BCL) of 1966. A number of hedging tools exist in the Islamic financial industry that could be considered a basis for derivative contracts within the bounds

of Islamic finance. These alternatives are *Bai Salam*, *Bai Urban*, *Khiyarat*, *Wad* and Islamic Swap (An Islamic Profit Rate Swap). Conventional derivatives are not permissible in *Shariah* because they involve interest (*riba*), gambling and pure games of chance (*maysir*), uncertainty (*gharar*) and exchange of one debt for another debt or *bai-al-kali-bi-al-kali* or *bai-al-dayn-bi-al-dayn*.

7.3 Research Findings

The major findings of the research were presented in Chapters Four, Five and Six, which were closely connected to the research questions, and may be summarised as follows:

One of the most significant findings to emerge from this study is that there are no specific laws and regulations governing Islamic banking and financial activities in Saudi Arabia. Currently, Islamic banking and financial activities are regulated and supervised, side-by-side with conventional commercial banking businesses, by SAMA under the Banking Control Law (BCL) of 1966. The lack of a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia has founded a self-regulatory process within the IFIs in the sense that each Islamic financial institution in Saudi Arabia is free to adopt its own *Shariah* governance without adhering either locally to SAMA or CMA standards or internationally to AAOIFI standards. In addition, the absence of a legal framework for Islamic banking and finance in Saudi Arabia has resulted in a questioning of the legal status of *Shariah* rulings and also a conflict of *Shariah* opinion (*fatwa*) by the *Shariah* scholars of different IFIs on the same issue, and an example of this conflict is the initial public offering of the Yanbu National Petrochemical Company (YANSAB). This absence of a legal framework has resulted also in the multiplicity of *Shariah* boards and different opinions of Islamic scholars for each IFI, in addition to a lack of certainty by clients as to whether the current practices of Islamic banking and financial activities in Saudi Arabia are compatible with the principles of *Shariah*. Finally, despite the fact that the Saudi capital market is one of the largest markets for Islamic banking and finance in the world because of the oil revolution, the absence of laws and regulations is an obstacle to foreign investors.

The second major finding is that there is no independent central *Shariah* board to regulate and supervise Islamic banking and financial activities in Saudi Arabia. In most cases, the Saudi banks unilaterally choose the members of the *Shariah* supervisory board of the bank. This practice is a result of the absence of laws that regulate the work of the *Shariah*

supervisory boards in Islamic financial institutions in Saudi Arabia. One of the implications of the absence of an independent central *Shariah* is the conflict in *fatwas* between *Shariah* scholars in Saudi Arabia, which may result in a breach of confidence among customers and investors. Another implication of this absence is weakness of regulation, oversight, accountability and responsibility within IFIs, due to the absence of a *Shariah* governance framework for IFIs.

The research findings have shown that there are no specialised commercial courts to look into commercial issues including Islamic banking issues in Saudi Arabia. Currently, the Committee for Settlement of Banking Disputes in SAMA which was issued, formed of three competent members from SAMA under a Royal Order on 1/3/1987, are responsible for looking into issues related to both Islamic and conventional banks and their customers. In addition, the Committee for the Resolution of Securities Disputes issued by the Board of the Capital Market Authority is responsible for looking into issues related to securities disputes including *sukuk* issuance. The problem is that these committees, known as quasi-judicial committees, do not have binding force to implement the provisions or the decisions issued by them, and their decisions are not conclusive because they are not *Shariah* courts. In addition, they are linked with the boards of directors of SAMA and CMA and the Ministry of Commerce, and as such are not an independent judiciary.

This study has found that the issuance of *sukuk* in Saudi Arabia is not consistent with the principles of *Shariah*, due to the absence of a regulatory and supervisory framework for *sukuk* issuance in Saudi Arabia. Currently, the issuance of *sukuk* in Saudi Arabia is regulated and supervised side-by-side with the issuance of shares and debt instruments by CMA under the Offers of Securities Regulations and the Listing Rules. In addition, there is no *Shariah* board or *Shariah* committee in CMA to regulate and supervise the issuance of *sukuk* in Saudi Arabia. This absence of a *Shariah* board raises the probability of conflict in opinions (*fatwas*) between Islamic scholars about the issuance of *sukuk* in Saudi Arabia. These differing opinions between Islamic scholars may result in significant damage to the issuer of *sukuk* in addition to breach of confidence among investors. The researcher has therefore proposed a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia including the issuance of *sukuk* in order to ensure compatibility with the principles of *Shariah*.

This research has found that the current uses of accepted risk transfer mechanisms in Islamic structured finance such as *Bai Salam* as an Islamic Forward, *Bai Urban*, Islamic Options (*Khiyarat*), *Wad* (a Unilateral Promise), Islamic Cross-Currency Swap (ICCS) and Islamic Profit Rate Swap (IPRS) are not applied effectively in Islamic financial institutions in Saudi Arabia. This is because of the absence of a legislative and regulatory framework for Islamic financial derivatives. The BCL of 1966 is considered the main legislation to regulate all banking and financial activities in Saudi Arabia including Islamic financial derivatives. Under this law, the Saudi Arabian Monetary Agency (SAMA) is responsible for the regulation of Saudi banks. This law is still applicable and has not been repealed or amended to accommodate the new financial innovations such as financial derivatives.

This study has found that some articles of the law of supervision of cooperative insurance companies in Saudi Arabia, and its implementing regulations, do not comply with *Shariah*, such as Articles 1, 70-2/e, 61-1, 59-2, 3-3, and 42 of the implementing regulations. In addition, there is some incompatibility between the Law of Supervision of Cooperative Insurance Companies and its implementing regulations in some articles. Moreover, there is no *Shariah* board or *Shariah* committee in SAMA to regulate and supervise Islamic insurance operations in Saudi Arabia so as to ensure that all internal and external operations of *takaful* comply with *Shariah* principles.

The research has found that there are many common features between Islamic and conventional bonds, especially asset-backed bonds. However, the issue of ownership is considered the main difference between them. *Sukuk* represent ownership in a tangible asset, whereas bonds represent the issuer's pure debt. On the other hand, there is a big difference between Islamic insurance and conventional insurance in the basic principles. The difference lies in the nature of the contract, in the way the risk is assessed and handled and in the relationship between the operator and the participant. For example, the operations of *takaful* are based on the principle of the *mudarabah* model, which is profit and loss sharing techniques, whereas conventional insurance is based on interest (*riba*) in its operations. Finally, Islamic financial derivatives differ from conventional derivatives contracts because conventional derivatives involve interest (*riba*), excessive uncertainty (*gharar*), and speculation or gambling (*maysir* or *qimar*) in their contracts, while the Islamic financial system is based on the profit and loss sharing between the parties to a transaction, as well as the promotion of ethical investments that enhance society and do not violate practices banned

in *Shariah*. Therefore, the researcher found that there is a possibility of a rapprochement between Islamic and conventional bonds because of the presence of common factors between them, whereas such rapprochement does not seem possible between Islamic and conventional insurance and also between Islamic financial derivatives and conventional derivatives, due to the great difference in the basic principles between them.

7.4 Recommendations

Some recommendations and suggestions emerged from the research, which relate to improving the legislative and regulatory framework for Islamic banking and finance in Saudi Arabia in line with the standards of the AAOIFI of Islamic finance and also the Malaysian experience. Thus, this thesis adopts the following recommendations:

1. There is an urgent need to enact special laws and regulations in order for Islamic banking and financial services in Saudi Arabia to be regulated and supervised by experts in the field of law and Islamic finance, whose qualifications include a PhD in Islamic finance. These proposed laws and regulations of Islamic banking and finance must be consistent with the provisions and principles of *Shariah* in order to fill the legislative and regulatory gap for Islamic banking and finance in Saudi Arabia. The absence of a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia could generate confusion between Islamic financial contracting forms and conventional finance.
2. It is necessary to establish an independent *Shariah* advisory body called the Saudi *Shariah* Advisory Council (SSAC) to regulate and supervise all Islamic banking and finance activities including *takaful* business, instead of SAMA. Members of the SSAC should be qualified in banking, finance, law and application of *Shariah*, particularly in the areas of Islamic banking and finance. The SSAC should be the highest *Shariah* authority for the determination of *Shariah* for Islamic financial business in the kingdom of Saudi Arabia. The SSAC should be given authority for the ascertainment of *Shariah* for the purposes of Islamic financial business, Islamic banking business, Islamic bonds (*sukuk*), *takaful* business, Islamic financial derivatives, and Islamic development financial business, or any other Islamic financial business. The SSAC should be the final arbiter in the interpretation of *Shariah* principles on Islamic banking and financial business.

3. There is additionally a need for specialised commercial courts to be established by the Saudi government, in order to look into commercial issues, including Islamic banking issues, in Saudi Arabia. The researcher recommends amending the present regulatory procedures for the Settlement of Banking Disputes in SAMA to cover disputes over Islamic banking and finance, and for the Resolution of Securities Disputes procedures in CMA to cover disputes over *sukuk* issuance until specialised commercial courts have been established to look into commercial issues including all Islamic banking and financial business. The specialised commercial courts should take into account the opinion of the proposed SSAC in the Islamic banking and finance issues in order to avoid conflicts of opinion between them.
4. It is necessary to amend Articles 1, 70-2/e, 61-1, 59-2, 3-3, and 42 of the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations, in order to comply with Islamic *Shariah* Law and also to avoid incompatibility between the law and its implementing regulations.
5. There is a need to amend the present regulations for the offering and issuance of securities in Saudi Arabia by the Board of the Capital Market Authority in order to cover a wider range of financial investment instruments, such as the issuance of *sukuk*. It is also necessary to establish a *Shariah* advisory body in the CMA, to be called the Securities Commission *Shariah* Advisory Council (SCSAC), in order to regulate and supervise the issuance of *sukuk* in Saudi Arabia. The SCSAC would be appointed by the proposed SSAC to ensure that the issuance of *sukuk* is in compliance with *Shariah* principles.
6. SAMA and CMA should adopt standards and recommendations that have been issued and developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); such as governance standards, *Shariah* standards, accounting standards, auditing standards, and ethics standards. They should also consider decisions and recommendations that have been issued by the Islamic Fiqh Council (IFC) regarding Islamic banking and finance.
7. There is a need to create new innovative financial products and services in the light of *Shariah*, instead of the Islamisation of certain conventional financial products.

7.5 Suggestions for Future Research

Islamic financial contracts in Saudi Arabia have been covered by few academic studies from a legal perspective. This study is one of the first to investigate three types of Islamic finance in Saudi Arabia from the *Shariah* point of view. The current study has concentrated on the issuance of *sukuk* (Islamic bonds), the models of *takaful* (Islamic insurance) and accepted risk transfer mechanisms in Islamic structured finance (Islamic derivatives) in Saudi Arabia from the *Shariah* perspective. Therefore, there is a need to cover more research in the fields of Islamic financial contracting forms in Saudi Arabia from the legal point of view. Some suggestions for future research concerning Islamic financial contracts in Saudi Arabia are as follows:

1. Ways to incorporate Islamic and conventional financial products and services in one contract offered by the Islamic financial institutions in Saudi Arabia.
2. The impact of the multiplicity of *Shariah* bodies in Islamic financial institutions on the development and growth of the Islamic finance industry in Saudi Arabia in the light of the lack of an independent *Shariah* advisory body governing Islamic banking and finance activities in Saudi Arabia.
3. Concentrating on the investigation of the new laws and implementing regulations of mortgage in Saudi Arabia from the *Shariah* point of view.
4. Promoting and advancing the *Shariah* governance framework for Islamic financial institutions in Saudi Arabia.
5. The impact of the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association, Inc. (ISDA) which has launched the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement on accepted risk transfer mechanisms in Islamic structured finance in Saudi Arabia.

7.6 Contribution to Knowledge

The main contribution of this study is to propose a legislative and regulatory framework for Islamic banking and finance in Saudi Arabia in order to reach satisfactory practices of these in Saudi Arabia in line with the standards of the AAOIFI of Islamic finance and also the Malaysian experience. This proposal will be presented to the Saudi Ministry of Finance and the central bank of Saudi Arabia (SAMA), as the first step towards the enactment of a law regulating Islamic banking and finance in Saudi Arabia. The proposal consists of three

chapters and key elements, namely the licensing requirement, the Saudi *Shariah* advisory council (SSAC) and the *Shariah* governance framework for Islamic financial institutions. These chapters and key elements have been carefully selected as a way to reform the current practices of Islamic banking and finance in Saudi Arabia, and also to accommodate the new financial innovations in the future. Finally, the researcher has taken into account some legal challenges that prevent the application of the proposed framework in Saudi Arabia, and has suggested some solutions to these legal challenges.

The second contribution is to fill the gap in the literature concerning Islamic financing contracts as an alternative to conventional loan products in Saudi Arabia from the *Shariah* point of view by using two mentalities and two languages; namely, Arabic and English. In this regard, the researcher conducted a critical literature review for three laws and regulations that govern Islamic banking and financial activities in Saudi Arabia, and also reviewed three types of Islamic finance in Saudi Arabia – Islamic bonds, Islamic insurance and Islamic financial derivatives – in order to reform and improve the existing laws and regulations governing Islamic banking and financial activities in Saudi Arabia. Moreover, the researcher conducted a comparative analysis between Islamic and conventional finance in order to determine the main similarities and differences between them. Another comparison was conducted between Saudi Arabia and Malaysia, in the field of laws and regulations governing Islamic financial contracting forms, in order to attempt to transfer the Malaysian experience to Saudi Arabia.

The third contribution is to reform the legal conflict between the Law of Supervision of Cooperative Insurance Companies and its implementing regulations in some articles, through the proposal to amend Articles No. 1, 70-2/e, 61-1, 59-2, 3-3, and 42 of the Law of Supervision of Cooperative Insurance Companies in Saudi Arabia, and its implementing regulations. In addition to the proposed reform of the legal conflict between the law and its implementing regulations, the researcher has suggested some solutions to reform the ineffectiveness of the participants' body (PB) in *takaful* companies, the ineffectiveness of some *Shariah* boards (SBs) and the weakness of technical and vocational rehabilitation for some *Shariah* boards, in order to improve the practices of Islamic insurance in Saudi Arabia.

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APPENDIX I

Banking Control Law

Issued by Royal Decree No. M/5 Dated 22.2.1386

Article One:

In this Law the following expressions shall have the definitions specified in this Article:

- a. "Bank" means any natural or juristic person practicing basically any of the banking business in the Kingdom.
- b. "Banking Business" means the business of receiving money on current or fixed deposit account, opening of current accounts, opening of letters of credit, issuance of letters of guarantee, payment and collection of cheques, payment orders, promissory notes and similar other papers of value, discounting of bills, bills of exchange and other commercial papers, foreign exchange transactions and other banking business.
- c. "National bank" means a bank the head office and branches of which are situated in the Kingdom. "Foreign Bank" means a bank with branches in the Kingdom and its head office outside it. "Agency" means the Saudi Arabian Monetary Agency. "Invested Capital," means the capital assigned by a foreign bank for the capital use of its branches in the Kingdom.

Article Two:

No person, natural or juristic, unlicensed in accordance with the provisions of this Law, shall carry on basically any of the banking business. However,

- a. Juristic persons licensed in accordance with another law or special decree to carry on banking business may practice such business within the limits of their intended purposes.
- b. Licensed moneychangers may practice basically exchange of currency in the form of notes and coins, but no other banking business.

Article Three:

All applications, for the grant of licenses to carry on banking business in the Kingdom, shall be addressed to the Agency which will study the applications after obtaining all the necessary

information and submit its recommendations to the Minister of Finance and National Economy. The license for a National Bank shall stipulate the following:

1. It shall be a Saudi Joint Stock Company.
2. The paid-up capital shall not be less than Rls. 2.5 million and all subscriptions towards share capital shall be payable in cash.
3. The founders and members of the board of directors shall be persons of good reputation.
4. The memorandum and articles of association shall be acceptable to the Minister of Finance and National Economy.

In the case of a Foreign Bank wishing to set up a branch or branches in the Kingdom, the grant of a license shall be subject to such conditions as the Council of Ministers may stipulate upon the recommendation of the Minister of Finance and National Economy. The license shall in all cases be issued by the Minister of Finance and National Economy after the approval of the Council of Ministers.

Article Four:

As an exception to the provisions of the previous Article, the licenses or authorizations previously issued to the persons carrying on banking business in the Kingdom and effective at the time of promulgation of this Law shall continue to be recognized. The Agency may, however, call such documents and information from these persons, as it may deem necessary. The Agency with the approval of the Council of Ministers may call upon them to comply with all or any of the provisions of Article 3 of this Law within such period as it may fix.

Article Five:

Any person not authorized basically to carry on banking business in the Kingdom is not allowed to use the word "Bank", or its synonyms, or any similar expression in any language on his papers or printed matter, or in his commercial address, or his name or in his advertisements.

Article Six:

The deposit liabilities of a bank shall not exceed fifteen times its reserves and paid-up or invested capital. If the deposit liabilities exceed this limit, the bank must within one month of

the date of submission of the statement referred to in paragraph 1 of Article 15, either increase its capital and reserves to the prescribed limit or deposit fifty percent of the excess with the Agency.

Article Seven:

Every bank shall maintain with the Agency at all times a statutory deposit of a sum not less than fifteen percent of its deposit liabilities. The Agency may, if it deems it to be in the public interest, vary the aforesaid percentage provided that it shall not be reduced below 10 percent nor increased to more than 17.5 percent. The Agency may, however, vary these two limits with the approval of the Minister of Finance and National Economy.

In addition to the statutory deposit provided for in the previous paragraph, every bank shall maintain a liquid reserve of not less than 15 percent of its deposit liabilities. Such reserve shall be in cash, gold or assets, which can be converted into cash within a period not exceeding 30 days. The Agency may, if deemed necessary, increase the aforesaid percentage up to twenty percent.

Article Eight:

No bank shall grant a loan or extend a credit facility, or give a guarantee or incur any other financial liability with respect to any natural or juristic person for amounts aggregating more than 25 percent of the Bank's reserves and paid-up or invested capital. The Agency may, in the public interest, and subject to such conditions as it may impose, increase this percentage up to 50 percent.

The provisions of the above paragraph do not apply to transactions between banks or between head offices and their branches or between these branches.

Article Nine:

No bank shall undertake the following transactions:

1. Granting a loan or extending credit facilities, or issuing a guarantee or incurring any other financial liability on the security of its own shares.
2. Granting, without security, a loan or credit facilities, or issuing a guarantee or incurring any other financial liability in respect of:

- a. Member of its Board of Directors or its Auditors.
- b. Establishments not taking the form of joint-stock companies in which any of its Directors or Auditors is a partner or is a manager or has a direct financial interest.
- c. Persons or establishments not taking the form of joint stock companies in cases where any of the Bank's directors or Auditors is a Guarantor.
3. Granting, without security, a loan or a credit facility or giving a guarantee or incurring any other financial liability in favor of any of its officials or employees for amounts exceeding four months salary of any such concerned person.

Any bank director or auditor or manager who contravenes paras 2 and 3 of this Article, shall be considered as having resigned his position.

Article Ten:

No bank shall undertake any of the following activities:

1. To engage, whether for its own account or on a commission basis, in the wholesale or retail trade including the import or export trade.
2. To have any direct interest, whether as a stock-holder, partner, owner, or otherwise, in any commercial, industrial, agricultural or other undertaking exceeding the limits referred to in para 4 of this Article, except when such interest results from the satisfaction of debts due to the bank, provided that all such interests shall be disposed of within a period of two years or within any such longer period as may be determined in consultation with the Agency.
3. To purchase, without the approval of the Agency, stocks and shares of any bank conducting its business in the Kingdom.
4. To own stocks of any other joint-stock company incorporated in the Kingdom, in excess of ten percent of the paid up capital of such a company provided that the nominal value of these shares shall not exceed twenty percent of the bank's paid-up capital and reserves; the above limits may, when necessary, be increased by the Agency.
5. To acquire or lease real estate except in so far as may be necessary for the purpose of conducting its banking business, housing of its employees or for their recreation or in satisfaction of debts due to the Bank.

In cases where a bank acquires real estate in satisfaction of debts due to it and such real estate is not necessary for the Bank's own banking business or housing of its employees or for their recreation, it shall dispose of it within three years of its acquisition or, in exceptional and justifiable circumstances, within such period or periods as may be approved by the Agency and subject to such conditions as it may deem fit to prescribe.

As an exception to the provisions of para 5 of this Article, the bank may, in special and justifiable circumstances and with the approval of the agency, acquire real estate, the value of which shall not exceed 20 percent of its paid-up capital and reserves.

Article Eleven:

Banks are precluded from undertaking any of the following operations except after the written approval of the Agency and according to the conditions it prescribes:

- a. Altering the composition of their paid-up or invested capital.
- b. Entering into any scheme of amalgamation or participation in the business of another bank or another establishment carrying on banking business.
- c. Acquiring shares in a company established outside the Kingdom.
- d. Ceasing to carry on banking business. In such a case, the Agency must, before agreeing to this cessation, ascertain that the Bank has made necessary arrangements to safeguard the rights of the depositors.
- e. Opening branches or other offices in the Kingdom and also opening of branches or other offices by national banks outside the Kingdom. Before granting the written license provided for under this paragraph, the Agency should get the approval of the Minister of Finance and National Economy.

Article Twelve:

No person shall be a director of more than one bank.

No person in the following cases shall be elected as a director or shall become a manager of any bank without prior written approval of the Agency:

- a. If he occupied a similar position in a banking concern that was wound up, even if the liquidation had been made before the promulgation of this Law. Such approval shall not be given by the Agency until it becomes clear that the person concerned was not responsible for that liquidation.

- b. If he was removed from a similar post in any banking establishment, even if such removal was before the promulgation of this Law. The approval of the Agency shall in this case be based on acceptable reasons.

Any director or manager of a bank, who is adjudicated bankrupt or convicted of a moral offense, shall be considered as having resigned his post.

Article Thirteen:

Every bank shall, before declaring distribution of any profits, transfer a sum equal to not less than 25 percent of its net profits, to the statutory reserve, until the amount of that reserve equals as a minimum of the paid-up capital.

(Amended Clause*) “No bank shall pay dividends or remit any part of its profits abroad, until its aggregate foundation expenditures and losses incurred have completely been written off, and after deducting not less than 10% of the value of capitalized expenditures until all these expenditures have been completely written off”.

(Amended in accordance with Royal Decree No. M/2 dated 6.1.1391 AH.)

Any action taken to declare or pay dividends in contravention to the provisions of this Article shall be considered null and void.

Article Fourteen:

Every bank shall appoint annually two auditors from amongst the approved list of auditors registered with the Ministry of Commerce and Industry. The Auditors shall submit a report on the Balance sheet and profit and loss account. This report shall include whether in the auditor's opinion the Bank's balance sheet duly and correctly represents its financial position and the extent of their satisfaction with any explanations or information they may have requested from the bank's manager or other staff.

With regards to banks taking the form of a company, the report referred to in the above paragraph shall be read together with the annual report of the Bank management in the General Meeting, which must be held within the six months following the end of the bank's financial year. The bank management should send copies of these two reports to the Agency.

The provisions of the first para of this Article shall apply to foreign banks in respect of their branches operating in the Kingdom. They should send a copy of the Auditor's report to the Agency.

Article Fifteen:

Every bank shall furnish the Agency by the end of the following month with a consolidated monthly statement of its financial position relating to the previous month, which shall be true and correct, and be in the form prescribed by the Agency. Every bank shall also furnish the Monetary Agency within six months of the close of its financial year with a copy of its annual balance sheet and profit and loss accounts certified by its auditors in the form prescribed by the Agency.

Article Sixteen:

The Monetary Agency may, with the approval of the Minister of Finance and National economy, issue general rules regarding the following matters:

1. The maximum limits of total loans that can be extended by a bank or banks.
2. The prohibition or limitation of specified categories of loans or other transactions.
3. Fixing the terms and conditions, which banks, should take into consideration when carrying out certain types of transactions for their customers.
4. The cash margins to be obtained by banks against specified categories of credits or guarantees.
5. The minimum ratio to be observed between the limits for loans and the collateral for such loans.
6. Fixing the assets to be maintained by each bank within the Kingdom. Such assets should not fall below a certain percentage of the Bank's deposit liabilities, which shall be fixed by the Agency from time to time.

The Agency may, from time to time, issue decisions concerning the following:

1. Definition of the expression "deposit liabilities" referred to in this Law.
2. Determination of bank holidays and bank business hours.

Article Seventeen:

The Agency may, at any time, request any bank to supply it, within a time limit it will specify and in the manner it will prescribe, with any information that it deems necessary for ensuring the realization of the purposes of this Law.

Article Eighteen:

The Agency may, with the approval of the "Minister of Finance and National Economy, conduct an inspection of the books and accounts of any bank, either by the Agency's own staff or by outside auditors assigned by it. The examination of the bank's books and accounts should take place in the bank's premises. In such a case the bank staff must produce all the required books and records of accounts and other documents in their custody or within their authority and must furnish any information they have relating to the bank.

Article Nineteen:

Any person who comes into possession of information during the performance of his duties in the implementation of this Law, is not allowed to disclose such information or to make use of it in any manner.

Article Twenty:

The Agency shall periodically publish combined statements of the principal data contained in the returns mentioned in Article 15.

Article Twenty One:

The Minister of Finance and National Economy, in exceptional circumstances, and with the prior approval of the Council of Ministers, may exempt any bank from any provision of this Law or from the regulations issued in execution thereof for a limited period and subject to such other conditions as may be laid down in each case.

Article Twenty Two:

If the Agency finds that a bank has failed to comply with the provisions of this Law, or with the provisions of any regulations issued under this Law, or if a Bank adopts a policy that

might seriously affect its solvency or liquidity, it may, with the approval of the Minister of Finance and National Economy, take one or more of the following measures:

- a. Appoint one or more advisers to advise the bank in the conduct of its business.
- b. Order the suspension or removal of any director or officer of the bank.
- c. Limit or suspend the granting of credits or the acceptance of deposits.
- d. Require the bank to take such other steps, as it may consider necessary.

If the Agency finds that a bank persistently contravenes the provisions of this Law or the decisions or regulations made thereunder, it may call upon such a bank to submit its reasons for the contravention, accompanied by its proposals to rectify the position within a stated period. If the Agency is of the opinion that such proposals are not sufficient for their purpose or if the bank fails to implement an agreed or prescribed course of action within the stated period, the Minister of Finance and National Economy may, subject to the approval of the Council of Ministers, revoke the license of the said bank.

Article Twenty Three:

1. Any person who contravenes the provisions of para 1 of Article 2, Article 5 and items a, b and c of para 1 of Article 11, Article 12 and Article 18, shall be liable to imprisonment for a term not exceeding two years and to a fine not exceeding Rls 5,000 for every day the offense continues or to either of these penalties.
2. Any person who contravenes the provisions of Article 19 shall be liable to imprisonment for a term not exceeding two years and to a fine not exceeding Rls 20,000 or to either of these penalties.
3. Any person who contravenes the provisions of Articles 8, 9 and 10 shall be liable to imprisonment for a term not exceeding six months and to a fine not exceeding Rls 10,000 or to either of these penalties.
4. Any person who contravenes the provisions of articles 7, 14 and 15 shall be liable to a fine not exceeding Rls 500 for every day the contravention continues.
5. Any person who contravenes any other provision of this Law or the regulations and decisions issued in execution thereof shall be liable to a fine not exceeding Rls 5,000.
6. In the event that offenses punishable according to paras 2,3 and 5 of this Article are committed by the same person for one purpose and provided that such offenses are

inter-related as to object and timing, they are to be considered as one offense punishable by one penalty.

In imposing the penalties contained in this Article it is to be observed that should an offense be punishable by more than one penalty, the offender shall be subjected to the severest.

Article Twenty Four:

The Chairman, the Managing Director, the Directors, head office Manager and Branch manager shall be responsible, each within his own jurisdiction, for any contravention of this Law or the decisions and rules issued for its execution.

Article Twenty Five:

The Minister of Finance and National Economy shall appoint a committee of three persons from outside the Agency and specify the conditions and measures to be observed in adjudging contraventions punishable under this Law at the request of the Agency.

Article Twenty Six:

The Deputy Premier and the Minister of Finance shall put this Law into effect and it shall come into force from the date of its publication.

APPENDIX II

Capital Market Authority

Offers of Securities Regulations

Issued by the Board of the Capital Market Authority Pursuant to its Resolution Number 2-11-2004 Dated 20/8/1425H Corresponding to 4/10/2004G Based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H

Amended by Resolution of the Board of the Capital Market Authority Number 1-33-2004 Dated 9/11/1425H Corresponding to 21/12/2004G

PART 1: PRELIMINARY PROVISIONS

Article One: Offer of securities

For the purpose of the application of these Regulations, offering securities shall mean issuing securities, inviting the public to subscribe therefor or the direct or indirect marketing thereof; or any statement, announcement or communication that has the effect of selling, issuing or offering securities, but does not include preliminary negotiations or contracts entered into with or among underwriters.

Article Two: Definitions

- a. Any reference to the “Capital Market Law” in these Regulations shall mean the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424H.
- b. Expressions and terms in these Regulations have the meaning which they bear in the Capital Market Law and in the Glossary of defined terms used in the Regulations and Rules of the Capital Market Authority, unless the contrary intention appears.

PART 2: GENERAL PROVISIONS

Article Three: Restrictions on offers of securities

- a. Securities may not be offered in the Kingdom except in accordance with these Regulations.

- b. Securities issued by a company in the Kingdom may not be offered unless the company is a joint stock company.

Article Four: The offeror

A person shall be considered an offeror of securities if he makes an offer or invites a person to make an offer which, if accepted, would give rise to the issue or sale of securities by him or by another person with whom he has made arrangements for the issue or sale of the securities.

Article Five: The offeree

a. Each of the following persons shall be considered an offeree:

1. any person to whom the offeror makes an offer;
2. any person to whose agent the offeror makes an offer where the agent is acting in his capacity as such; or
3. any person who receives during the period of the offer an offer of securities from a person (referred to here as the “distributor”) to whom the offeror has made an offer of such securities and the offeror knows or should reasonably know that the distributor makes such an offer.

b. For the purposes of paragraph (a) of this Article, the offeror will be deemed not to know that a person is acting as an agent for a third party or as a distributor unless he receives information or a representation that such person is acting in such capacity.

Article Six: Types of Offers of Securities

An offer of securities may be a public offer, a private placement or an exempt offer.

PART 3: PUBLIC OFFERS

Article Seven: Definition of public offer

An offer of securities is a public offer if it does not fulfil the conditions of a private placement and does not fall within the categories of an exempt offer.

Article Eight: Public offer requirements

Securities may not be offered by way of a public offer unless all the requirements and conditions provided for in the Listing Rules have been fulfilled.

PART 4: PRIVATE PLACEMENTS

Article Nine: Definition of private placement

An offer of securities is a private placement if it is not an exempt offer and where the following two conditions are fulfilled:

1. the amount payable by each offeree in the Kingdom is not less than Saudi Riyals 1 million or an equivalent amount; and
2. the offer is made only to any of the following persons:
 - the government of the Kingdom;
 - SAMA;
 - any supranational authority recognised by the Authority;
 - the Exchange and any other stock exchange recognised by the Authority;
 - the Depositary Center;
 - authorised persons acting for their own account;
 - clients of an authorised person, provided that the offer to the client is made through the authorised person;
 - institutions acting for their own account; or
 - any other persons that the Authority considers exempt.

Article Ten: Private placement memorandum requirements

- a. No person may offer securities by way of private placement unless the Authority has approved the private placement memorandum. The private placement memorandum constitutes a prospectus as described in the Capital Market Law.
- b. The private placement memorandum must contain all information which is necessary to enable an investor to make an assessment of the activities of the issuer of the securities, and of its assets and liabilities, financial position, management and prospects, profits and losses, in addition to information in relation to the rights and privileges attaching to the securities being offered.

- c. Annex (1) to these Regulations specifies the minimum information, and the form of disclaimer which must be included in the private placement memorandum.

Article Eleven: Obligations of the person wishing to offer securities by way of private placement

A person wishing to offer securities by way of private placement must:

1. submit an application to the Authority signed by an authorised signatory containing such information as is specified in Annex (2) to these Regulations;
2. submit the private placement memorandum for approval by the Authority; and
3. pay such fees to the Authority as the Authority may specify.

Article Twelve: Powers and obligations of the Authority with respect to the private placement memorandum

- a. The Authority will endeavour to review the private placement memorandum within 30 days of receiving the application in order to consider whether to approve it.
- b. If having reviewed the private placement memorandum the Authority considers that the proposed offer of securities may not be in the interest of investors in the Kingdom or may result in a breach of the Capital Market Law or the Implementing Regulations then it may take any of the following actions:
 1. carry out any enquiries which it considers appropriate including requiring the concerned person or its representative to appear before the Authority to answer the questions of the Authority and to explain any matters that the Authority considers relevant to the application;
 2. require the concerned person or others to provide additional information or to confirm, in such manner as the Authority may specify, that the information provided is accurate; or
 3. defer making any decision for such period as may be reasonably necessary to carry out a further study and examination or to allow for additional information to be provided.
- c. If, having taken action pursuant to paragraph (b) of this Article, the Authority determines that the offer to be made pursuant to the private placement memorandum is still not in the interest of investors in the Kingdom or may result in a breach of the Capital Market Law or the Implementing Regulations, the Authority may, after giving the offeror a suitable opportunity

to be heard, issue a "notification" to the offeror stating that the private placement memorandum has not been approved, or publish a "notice" prohibiting the offer, sale or transfer of the securities to which the private placement memorandum relates.

- d. The applicant has the right to appeal to the Committee in respect of any decisions or actions that the Authority takes under the provisions of this Article.

Article Thirteen: Distribution of the private placement memorandum

The private placement memorandum approved by the Authority must be made available to the offerees free of charge at a specific address in the Kingdom or via the internet from the time the securities are first offered until the end of the period during which the offer remains open.

Article Fourteen: No continuing obligations

Except as set out in the provisions of this part, an offeror of securities by way of a private placement is not required to produce, or to register with the Authority or the Exchange, any document relating to the offer of the securities, or to inform the Authority of any material developments relating to the securities.

Article Fifteen: Restrictions on secondary market activity

- a. A person (referred to as a "transferor") who has acquired securities pursuant to a private placement may not offer or sell such securities to any person (referred to as a "transferee") unless the price to be paid by the transferee for such securities equals or exceeds Saudi Riyals 1 million.
- b. If what is provided for in paragraph (a) of this Article cannot be fulfilled because the price of the securities being offered or sold to the transferee has declined since the date of the original private placement, the transferor may offer or sell securities to the transferee if their purchase price during the period of the original private placement was equal to or exceeded Saudi Riyals 1 million.
- c. If what is provided for in paragraphs (a) and (b) of this Article cannot be fulfilled, a transferor may offer or sell the securities if he sells his entire holding of such securities to one transferee.
- d. The provisions of paragraphs (a), (b) and (c) of this Article shall apply to all subsequent transferees of such securities.
- e. The restrictions in this Article shall cease to apply upon approval of listing on the Exchange of securities of the same class as the securities that are subject to such restrictions.

PART 5: EXEMPT OFFERS

Article Sixteen: Exempt offer

- a. An offer of securities is exempt from the public offer and of the private placement requirements in any of the following circumstances:
 1. if the securities are issued by the government of the Kingdom;
 2. if the securities are issued by a supranational authority recognised by the Authority;
 3. if the securities are offered to no more than 60 offerees in the Kingdom and the minimum amount payable per offeree is not less than Saudi Riyals 1 million or an equivalent amount. An issuer may not treat an offer of its securities as being exempt by virtue of this paragraph more than once in a 12- month period;
 4. if the total value of the securities offered by the issuer is less than Saudi Riyals 5 million or an equivalent amount. An issuer may not treat an offer of its securities as being exempt by virtue of this paragraph more than once in a 12- month period;or
 5. if the issuer of the securities is a member of a group of companies and the issuer offers the securities to a member of the same group.
- b. The Authority may, in circumstances other than those described in paragraph (a) of this Article and upon application of a person seeking to make an offer of securities, determine that such offer of securities shall be treated as an exempt offer subject to compliance with such limitations as the Authority may impose.

Article Seventeen: Exempt offer requirements

- a. No person may offer securities by way of an exempt offer unless it notifies the Authority in writing in accordance with the instructions set out in Annex (3) to these Regulations, at least 10 days prior to the proposed date of the offer.
- b. If the Authority determines that the proposed offer of securities is not in the interest of investors in the Kingdom or may result in a breach of the Capital Market Law or the Implementing Regulations, the Authority may, after giving the offeror a suitable opportunity to be heard, issue a "notification" to the offeror stating that the offer is not to be made, or publish a "notice" prohibiting the offer, sale or transfer of the securities to which the exempt offer relates.

- c. The offeror has the right to appeal to the Committee in respect of any decisions or actions that the Authority takes under the provisions of this Article.

Article Eighteen: No continuing obligations

Except as set out at Article 17 of these Regulations, an offeror of securities by way of an exempt offer is not required to produce, or to register with the Authority or the Exchange, a prospectus or any other document relating to the offer of the securities, or to inform the Authority of any material developments relating to the securities.

Article Nineteen: Restrictions on secondary market activity

- a. A person (referred to as a “transferor”) who has acquired securities pursuant to an exempt offer under any of sub-paragraphs (3) or (5) of paragraph (a) of Article 16 may not offer or sell such securities to any person (referred to as a “transferee”) unless the price to be paid by the transferee for such securities equals or exceeds Saudi Riyals 1 million.
- b. If what is provided for in paragraph (a) of this Article cannot be fulfilled because the price of the securities being offered or sold to the transferee has declined since the date of the original exempt offer, the transferor may offer or sell securities to the transferee if their purchase price during the period of the original exempt offer was equal to or exceeded Saudi Riyals 1 million.
- c. If what is provided for in paragraphs (a) and (b) of this Article cannot be fulfilled, the transferor may offer or sell the securities if he sells his entire holding of such securities to one transferee.
- d. The provisions of paragraphs (a), (b) and (c) of this Article shall apply to all subsequent transferees of such securities.
- e. The restrictions in this Article shall cease to apply upon approval of listing on the Exchange of securities of the same class as the securities that are subject to such restrictions.

PART 6: LIABILITY FOR INCORRECT DOCUMENTS

Article Twenty: Liability for incorrect or incomplete documents

Liability for an incorrect or incomplete private placement memorandum or prospectus shall be determined in accordance with Article 55 of the Capital Market Law.

PART 7: PUBLICATION AND ENTRY INTO FORCE

Article Twenty One: Publication and entry into force

These Regulations shall become effective upon their publication.

APPENDIX III

Law on Supervision of Cooperative Insurance Companies

Issued by Royal Decree No M/32 dated 31 July 2003

Article One:

Insurance in the Kingdom of Saudi Arabia shall be provided by insurance companies registered in the Kingdom operating in accordance with the practice of cooperative insurance in line with the provisions of the Articles of Incorporation of the National Company for Cooperative Insurance issued by Royal Decree No (M/5) dated 17/4/1405 H, and not inconsistent with the provisions of Shari'ah.

Article Two:

Subject to the provisions of the Cooperative Health Insurance Law, promulgated by Royal Decree M/10 dated 1/5/1420 H, The Saudi Arabian Monetary Agency (the "Agency") shall, in the course of implementing the Regulations, have the following powers:

1. To receive applications for establishing cooperative insurance and re-insurance companies, study the applications to ensure compliance with applicable rules and conditions and, if approved, refer the applications to the Ministry of Commerce and Industry to take the necessary legal requirements.
2. To supervise and technically control insurance and re-insurance activities in accordance with the principles specified in the implementing regulations of this Law and the means of control employed by the Agency, specially the following:
 - a. Regulating and approving rules for the investment of premiums of insurance and re-insurance operations, and designing a formula to distribute the surplus of insurance and re-insurance operations among shareholders and the insured, provided that separate accounts are kept for shareholders, the insured and insurance operations.
 - b. Determining the sums of money required to be deposited with one of the local banks in order to provide each of the different types of insurance.

- c. Approving standard forms of insurance and re-insurance policies, and determining the minimum amounts of third party insurance coverage, subject to the provisions of laws applicable in this regard.
- d. Setting rules and restrictions determining the method of investing the assets of insurance and re-insurance companies.
- e. Setting general rules determining the assets which each company shall keep inside and outside the Kingdom, the minimum and maximum for each type of insurance, and the conditions that shall be observed in each type, and the
- f. Setting rules and restrictions which protect the rights of the beneficiaries, and ensure the ability of the insurance companies to satisfy claims and obligations.

Article Three:

An Insurance or re-insurance company may not be formed in the Kingdom of Saudi Arabia except by a license issued pursuant to a Royal Decree upon a resolution by the Council of Ministers and a recommendation by the Minister of Commerce and Industry according to Article Two of this Law, and subject to the following:

1. The company shall be a public joint-stock company.
2. The company's principal object shall be to perform any insurance and re-insurance activity and shall not undertake other objects unless they are necessary or complementary [to its principal object]. Insurance companies may not directly own companies or brokerage establishments, and re-insurance companies may not own re-insurance brokerage companies or establishments. However, insurance companies – upon the approval of the Saudi Arabian Monetary Agency– may own companies or establishments that act as brokers in re-insurance activities.
3. The paid-up capital of the insurance company shall not be less than one hundred million Saudi riyals and the paid-up capital of the re-insurance company or the insurance company carrying out re-insurance activities simultaneously shall not be less than two hundred million Saudi riyals. The capital may not be changed without the approval of the Saudi Arabian Monetary Agency, and pursuant to the Companies Law.

Article Four:

The implementing regulations shall specify the insurance operations governed by this Law, and each insurance company shall specify the types of insurance it shall provide.

Article Five:

An insurance or re-insurance company - upon commencing business - may not suspend its insurance activities without the prior approval of the Saudi Arabian Monetary Agency. This is to ensure that insurance companies take all necessary measures to safeguard the rights of the insured and the investors.

Article Six:

Selection of members of the board of directors of insurance and re-insurance companies shall be subject to the approval of the Saudi Arabian Monetary Agency in accordance with the criteria specified for in the implementing regulations.

Article Seven:

The chairman of the board of directors of insurance or re-insurance company, managing director, a member of the board of directors and general manager shall be liable, each within the limits of his authority, for the company's violation of any of the provisions of this Law or its implementing regulations.

Article Eight:

The Saudi Arabian Monetary Agency may inspect the records and accounts of any insurance or re-insurance company through the Agency's employees or auditors appointed by it, provided that the inspection be carried out at the site of the insurance or re-insurance company. In this case the employees of the company shall submit whatever is in their possession or under their authority or records, data, and documents requested from them, and disclose any information they have, relating to the company, to the employees of the Agency or whoever it may appoint as auditors.

Article Nine:

An insurance or re-insurance company may not open any branch or office inside or outside the Kingdom, agree to merge with, own any insurance or banking activity, have control thereof, or own shares of another insurance or re-insurance company without the written approval of the Saudi Arabian Monetary Agency.

Article Ten:

1. The general assembly of the insurance or re-insurance company shall annually appoint two auditing offices from among the certified accountants licensed to practice the profession in the Kingdom and shall determine their fees.
2. The auditors shall include in their annual report presented to the general assembly– in addition to the data provided for in the Companies Law– their opinion as to whether the financial statements of the company correctly reflect its true financial position on the date of the budget and the results of its activities during the fiscal year which expires on that date, and as to whether the preparation, presentation and audit of these statements conform to the generally accepted accounting principles applied in the Kingdom.
3. Financial statements and the auditors' report shall be published within three months from the date of the end of the company's fiscal year.

Article Eleven:

The Saudi Arabian Monetary Agency may at any time request any insurance or re-insurance company to submit to it– at the time and in the form it determines– any information it deems necessary to fulfill the purposes of this Law. It shall also send to the Saudi Arabian Monetary Agency at its request the following:

1. A statement of the returns and expenses of each insurance type.
2. A detailed statement of the insurance activities carried out by the company during the stated period.
3. Statistical statements and general information about the activities of the company.
4. A statement of the investments of the company.
5. Any other information requested by the Saudi Arabian Monetary Agency.

Article Twelve:

It is prohibited for any person who obtains any information, while carrying out any work related to the application of the provisions of this Law, to disclose or benefit from it in any way.

Article Thirteen:

All insurance and re-insurance companies shall submit to the Department of Zakat and Income Tax their zakat or tax returns, the audited financial statements and any other information or documents which the Department deems necessary for the purpose of determining the amount subject to zakat or taxation in accordance with the provisions of the Tax Law, the Zakat Collection Law and their implementing regulations and payment of the sums due, within the times specified by the Law.

Article Fourteen:

Insurance and re-insurance companies governed by this Law shall deposit in one of the local banks, a legally required deposit to the order of the Saudi Arabian Monetary Agency, and the implementing regulations shall determine the restrictions relating to this deposit.

Article Fifteen:

The insurance and re-insurance companies shall allocate a part of their annual profits, not less than 20%, as a legal reserve, until the total reserve amounts to 100% of the capital paid.

Article Sixteen:

All insurance and re-insurance companies shall setup the required reserves for their insurance types, and other reserves as provided for in the implementing regulations of this Law.

Article Seventeen:

All insurance and re-insurance companies governed by the provisions of this Law shall keep a separate account for each type of insurance as specified in the implementing regulations of this Law. They shall also keep records and books to record insurance policies issued by the company, names and addresses of the holders of such policies and the date of concluding each policy, its effectiveness, prices and conditions provided for in it. Any change or

amendment occurring in such policies shall also be recorded in these records and books. The Saudi Arabian Monetary Agency may issue the decisions it deems necessary to compel insurance companies to record in the books and records any data it deems necessary to exercise its authority of control and supervision. The data contained in the records and books mentioned above may be entered in the computer in accordance with the rules and procedures provided for in the implementing regulations of the Law of Commercial Books.

Article Eighteen:

The Saudi Arabian Monetary Agency shall set the necessary conditions for issuing licenses to practice self-employment professions relating to the insurance activity, especially the following:

1. Insurance brokers.
2. Insurance Consultants.
3. Inspection and loss assessment experts.
4. Specialists in settlement of insurance claims.
5. Actuaries.

Licenses for these professions shall be issued by the Ministry of Commerce and Industry, and the Saudi Arabian Monetary Agency shall control and supervise the activities of the professions referred to.

Article Nineteen:

If the Saudi Arabian Monetary Agency finds that any of the insurance or re-insurance companies has violated the provisions of this Law or its implementing regulations or followed a policy liable to adversely affect its ability to fulfill its obligations, the Agency may take one or more of the following measures:

1. Appointing one consultant or more to provide consultation to the company in relation to the management of its activities.
2. Suspending any member of the Board of Directors or any of its employees proven to be responsible for the violation.
3. Preventing the company from accepting any new shareholders, investors or members in any of its insurance activities or restricting it in this respect.
4. Compelling the company to take any other measures the Agency deems necessary.

If the Agency finds that the company persists to violate the provisions of this Law or its implementing regulations and does not respond to any of the measures taken by the Agency in accordance with this Article, and despite the infliction of the punishments provided for in this Law, the Agency may request the dissolution of the company.

Article Twenty:

One or more committees shall be formed based on a Resolution by the Council of Ministers, upon the recommendation of the Minister of Finance, composed of three specialized members, at least one of whom shall be a legal counselor, to be entrusted with the settlement of disputes occurring between insurance companies and their clients, or between these companies and others that may substitute for the insured, and shall decide on cases of violations of control and supervision instructions for the licensed insurance and re-insurance companies, and the violations of those practicing self-employment professions referred to in Article Eighteen of this Law. Prosecuting before the Committee – in connection with these violations – is represented by the employees appointed by a decision of the Minister of Finance.

Decisions of these Committees may be appealed before the Board of Grievances.

Article Twenty One:

Without prejudice to any harsher punishment provided for in any other law, anyone who violates any provision of this Law shall be punished with a fine not exceeding one million riyals and imprisonment for a period not exceeding four years, or by either.

Article Twenty Two:

Without prejudice to the powers of the committee provided for in Article Twenty of this Law, the Board of Grievances shall have jurisdiction in the following:

1. Deciding all disputes between insurance companies and re-insurance companies, or between companies of either type.
2. Deciding cases of violations of this Law and the implementation of the punishment provided for in Article Twenty One.

3. Initial review of the case in any suit in which the Monetary Agency or the Committee formed in accordance with Article Twenty requests the infliction of the punishment of imprisonment.
4. Prosecution before the Board of Grievances shall be carried out by the employees appointed pursuant to a decision issued by the Minister of Finance.

Article Twenty Three:

The implementing regulations of this Law shall be issued by a decision of the Minister of Finance, and shall be published within sixty days from the date of publication of this Law, and shall come into effect on the date of the enforcement of this Law.

Article Twenty Four:

Subject to what is stated in Article One of this Law whatever is not provided for therein shall be governed by the Companies Law, to the extent permitted by the nature of such type of companies.

Article Twenty Five:

This Law shall be published in the Official Gazette and shall come into effect after ninety days from the date of its publication.